PCAOB
Public Company Accounting Oversight Board

Forum on Auditing Smaller Broker-Dealers

October 25, 2012

Jersey City, NJ

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Public Company Accounting Oversight Board

Opening Remarks

Jay D. Hanson
Board Member, PCAOB
October 25, 2012
Jersey City, NJ

Caveat

One of the benefits of today's session is that you will hear firsthand from one of the PCAOB Board members and numerous PCAOB staff. You should keep in mind, though, that when we share our views they are those of the speaker alone, and do not necessarily reflect the views of the Board, its members or staff.

Broker-Dealers:

Landscape, Lessons from Liquidations, and Trends

Andres Vinelli

Office of Research and Analysis

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I. Broker-Dealers: Landscape

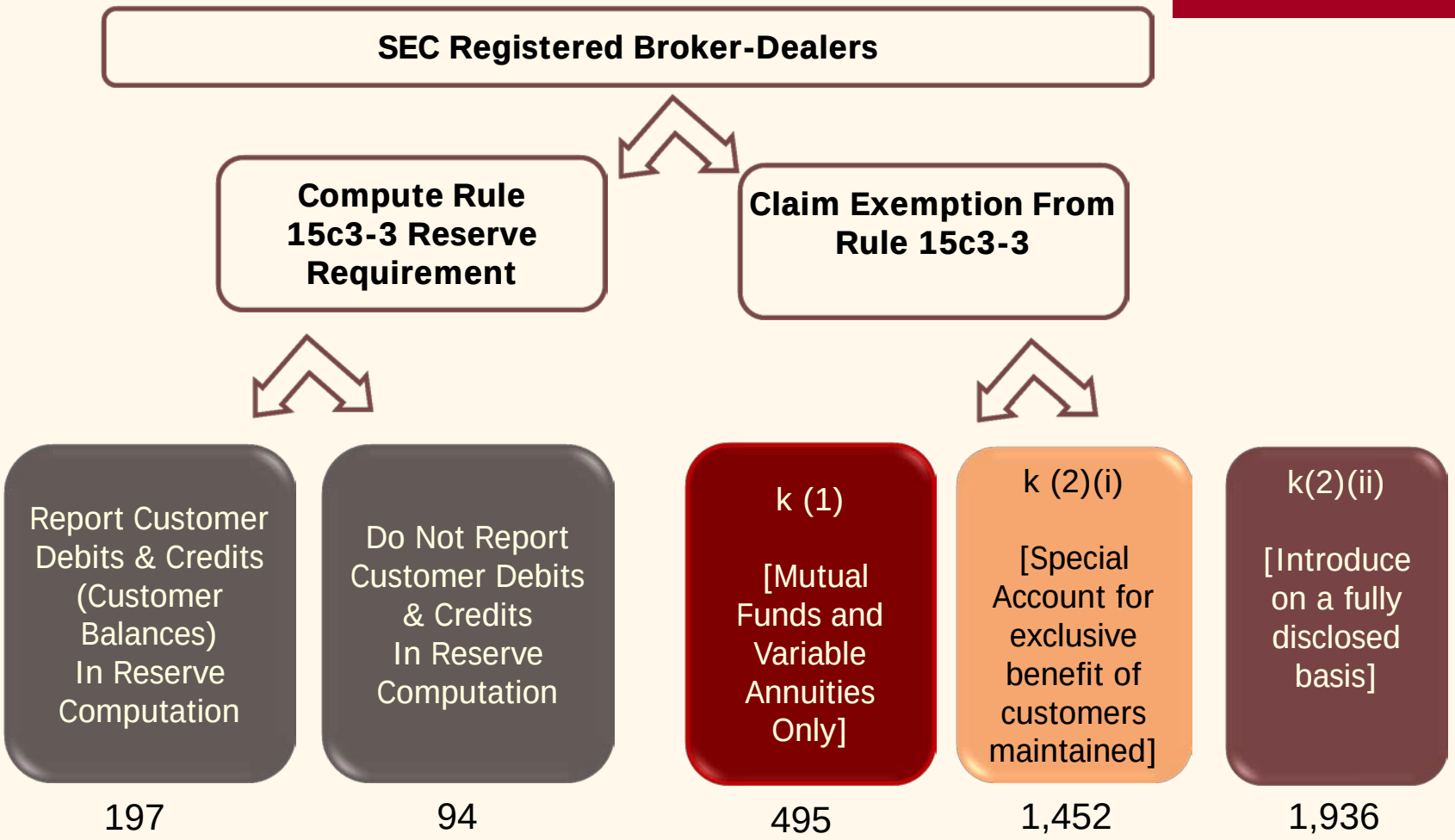
The Broker-Dealer Landscape

- We can evaluate the broker-dealer landscape by various data points from the annual audited reports and the unaudited FOCUS reports:
  - Broker-Dealers Classified by Exemptions from Rule15c3-3
  - Auditor PCAOB Inspection Program
  - Net Capital Minimum Requirement
- Population Summarized:

All broker-dealers that filed 2011 FYE audited financial statements as of May 17, 2012	4,391
Not all fields relevant to this report are available	115
Population summarized	**4,276**

Source: Information is based on firms registered with the PCAOB that issued audit reports for brokers and dealers filed with the SEC through May 17, 2012 for fiscal years ended during 2011.

Classification Scheme for Broker-Dealers



Source: Securities Exchange Act Rule 15c3-3 exemption information obtained from FINRA FOCUS Report data as of December 31, 2011 filed by the 4,276 brokers and dealers.

Broker-Dealers Classified by Auditor Inspection Program

	Report Customer Debits & Credits In Reserve Computation	Do Not Report Customer Debits & Credits In Reserve Computation	k (1)	k (2)(i)	k(2)(ii)	Other Combo	Total
Audited by firm inspected on an annual basis	145	44	121	240	326	32	908
Audited by firm that also reported auditing issuers	28	22	174	565	717	35	1,541
Audited by firm that did not report auditing issuers	24	28	200	647	893	35	1,827
Total	197	94	495	1,452	1,936	102	4,276

Source: Securities Exchange Act Rule 15c3-3 exemption information obtained from FINRA FOCUS Report data as of December 31, 2011 filed by the 4,276 brokers and dealers. Information on whether the firm audits issuers was obtained from the most recent Form 2 filed with the PCAOB through July 10, 2012.
[Section 102(d) of the Sarbanes-Oxley Act and PCAOB Rule 2200 require registered public accounting firms to file an annual report on Form 2 with the PCAOB covering the twelve month period ended March 31 by June 30.]

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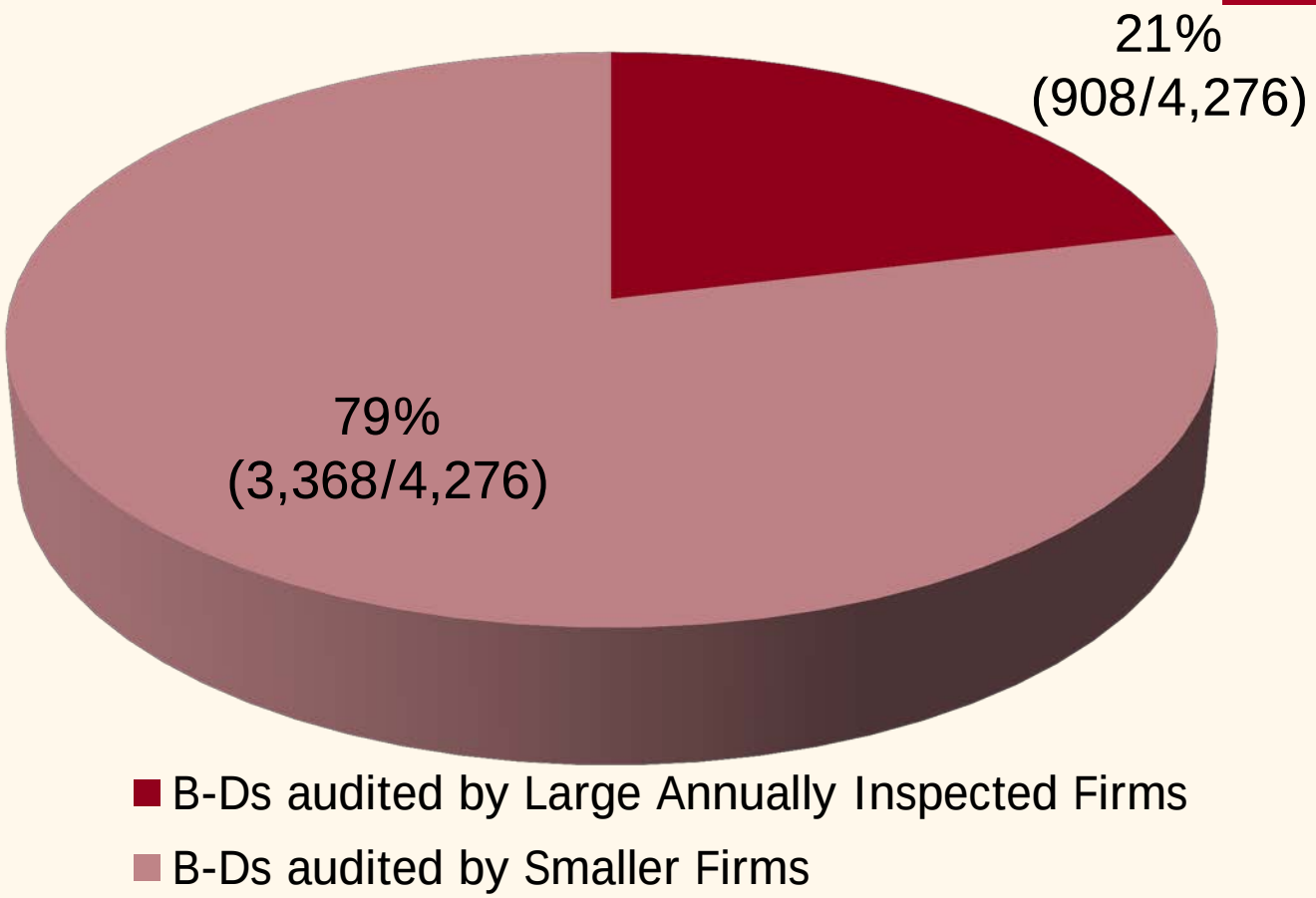
Small Firms Audit a Large % of Broker-Dealer Population



Source: Information obtained from audit reports issued by firms registered with the PCAOB for the 4,276 brokers and dealers.

Net Capital Requirement Computation as an Indicator of Business Activity

Minimum Requirement	
$5,000 (B-Ds that don't receive, hold, owe, carry, etc.)	2,280
$25,000 (B-Ds of only mutual funds, insurance, etc)	113
$45,000 (CFTC Registered Introducing B-Ds)	31
$50,000 (Introducing B-Ds that receive but don't hold)	331
$100,000 (Dealers or (k)(2)(i) exempt B-Ds)	730
$250,000 (Carrying B-Ds and various other B-Ds)	600
$1,000,000 (CFTC FCMs and various other B-Ds)	81
$1,500,000 (Prime Brokers)	27
Not “Fixed Dollar” Amount	83
Total	4,276

Source: Minimum dollar net capital requirement (“Minimum Requirement”) data obtained from the FINRA FOCUS Reports as of December 31, 2011 filed by the 4,276 brokers and dealers. The general description of the business activities obtained from the Minimum Requirements provisions for brokers and dealers under Securities Exchange Act Rule 15c3-1.

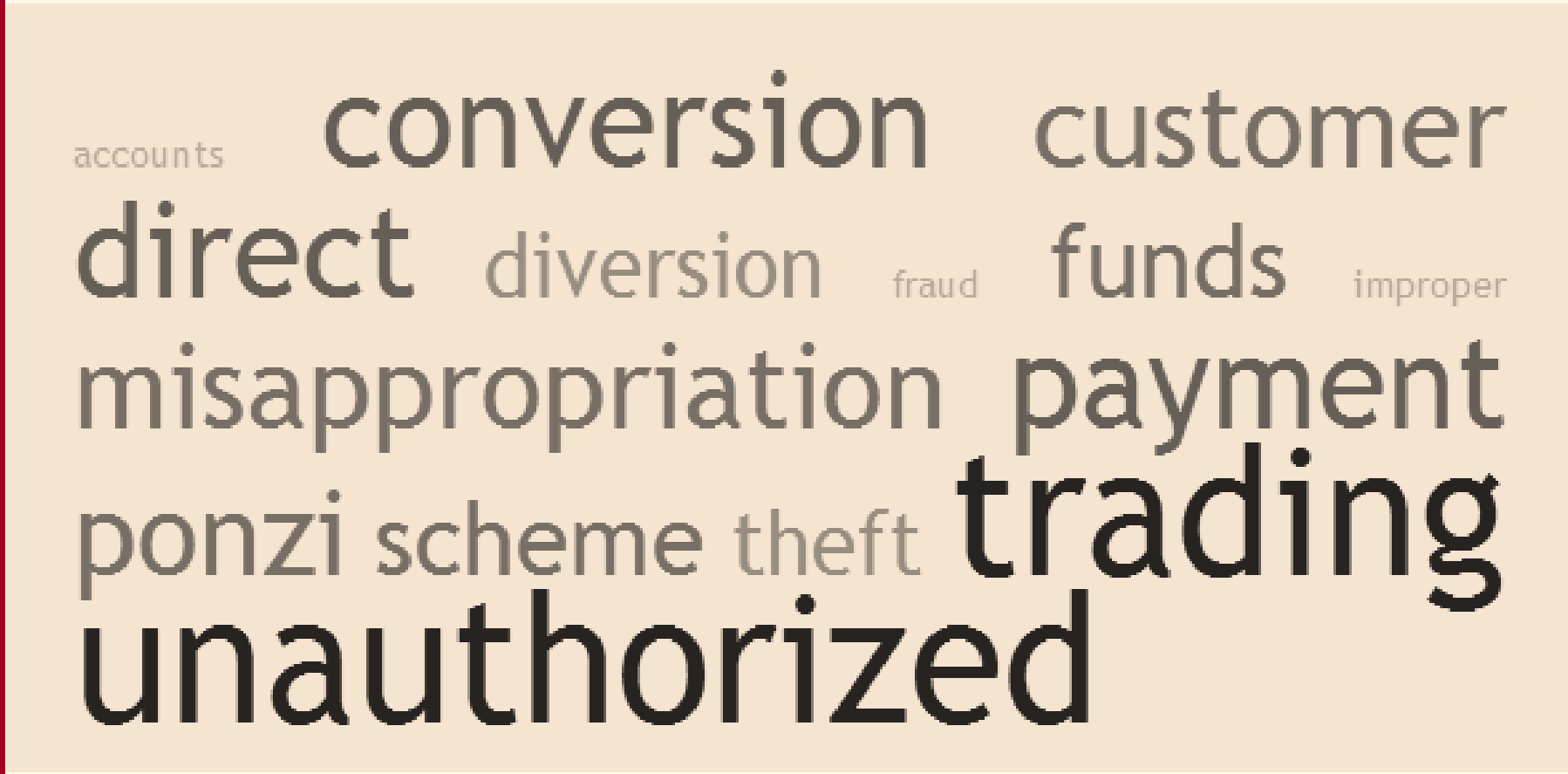
II. Lessons from SIPC Liquidations

Securities Investor Protection Act

- "SIPC is **not** the FDIC. The Securities Investor Protection Corporation does **not** offer to investors the same blanket protection that the Federal Deposit Insurance Corporation provides to bank depositors."
- SIPC "replaces **missing** stocks and other securities where it is possible to do so"

Source: SIPC website: http://www.sipc.org/How/Brochure.aspx

SIPC's Description of Causes for Failure



Source: SIPC

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Broker-Dealers Subject to Liquidation or Direct Payment Procedures Commenced by SIPC After 1/1/95 and Paid as of 12/31/10

	Number of B-D Liquidations	% of Liquidations	SIPC Customer Advances in Liquidations (Millions USD)	% of Customer Advances
B-Ds that Claim Exemption to 15c3-3	65	85%	97	11%
B-Ds that are 15c3-3 Computing, (Except Madoff)	11	14%	75	8%
Madoff Liquidation (In Progress)	1	1%	756	81%
	77	100%	928	100%

- Excluding Madoff, 86% of SIPC liquidations and 56% of customer advances were for B-Ds that claim exemption from Rule 15c3-3
- The average customer advances paid for B-Ds that claim exemption was $1.6 million
- The average customer advances paid for B-Ds that don't claim exemption was $7.4 million (excluding Madoff)

Source: Payment data obtained from SIPC. Securities Exchange Act Rule 15c3-3 exemption status obtained from the last FINRA FOCUS Report filed by the 77 brokers and dealers prior to their liquidation under the Securities Investor Protection Act.

SIPC Customer Advances as a Proxy for Economic Damage

- Advances from SIPC fund underestimate economic costs of broker-dealer misconduct
  - Cap on coverage of $500,000 ($250,000 for cash)
  - Customer advances are reduced by amounts recovered in litigation, asset liquidations, etc.
  - Scope of SIPC coverage is limited by SIPA
  - On some issues, there are differing views of what is legally covered under SIPA (e.g., repos)
- Nonetheless we use SIPC Customer Advances as one aspect of examining how various attributes may be related to relatively larger customer losses

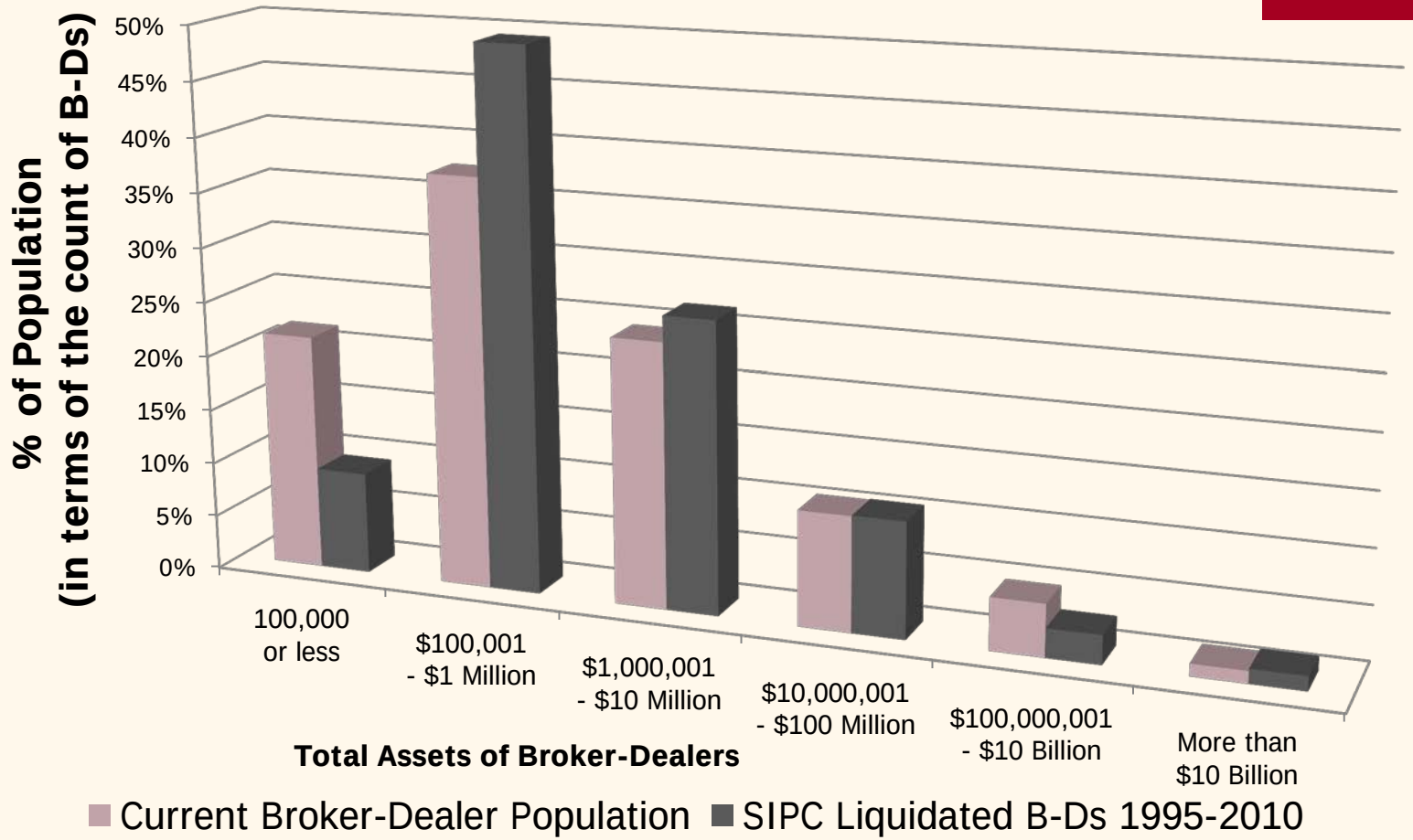
Net Capital Requirement Computation as an Indicator of Business Activity of SIPC Liquidated B-Ds

Minimum Requirement	Current Broker-Dealer Population	SIPC Liquidated Broker-Dealers
$5,000 (B-Ds that don't receive, hold, owe, carry, etc.)	53%	29%
$25,000 (B-Ds of only mutual funds, insurance, etc)	3%	1%
$45,000 (CFTC Registered Introducing B-Ds)	1%	0%
$50,000 (Introducing B-Ds that receive but don't hold)	8%	14%
$100,000 (Dealers and (k)(2)(i) exempt B-Ds)	17%	32%
$250,000 (Carrying B-Ds and various other B-Ds)	14%	18%
$1,000,000 (CFTC FCMs and various other B-Ds)	2%	1%
$1,500,000 (Prime Brokers)	1%	0%
Not Fixed Dollar Amount	2%	4%
Total	100%	100%

Scope: Comparison of the business activities (based on Minimum Requirements) between the 4,276 brokers and dealers and the 77 brokers and dealers subject to liquidation under the Securities Investor Protection Act (commenced after January 1, 1995 and paid as of December 31, 2010).

Source: Information on the broker and dealer Minimum Requirements obtained from the FINRA FOCUS Report as of December 31, 2011 for the 4,276 brokers and dealers and the FINRA FOCUS Report filed by the 77 brokers and dealers prior to their liquidation under the Securities Investor Protection Act.

Total Assets of SIPC Liquidated B-Ds vs. Total Assets of Today's B-Ds



Scope: Comparison of total assets between the 4,276 brokers and dealers and the 77 brokers and dealers subject to liquidation under the Securities Investor Protection Act (commenced after January 1, 1995 and paid as of December 31, 2010).

Source: Information on total assets obtained from the FINRA FOCUS Report as of December 31, 2011 for the 4,276 brokers and dealers and the FINRA FOCUS Report filed by the 77 brokers and dealers prior to their liquidation under the Securities Investor Protection Act.

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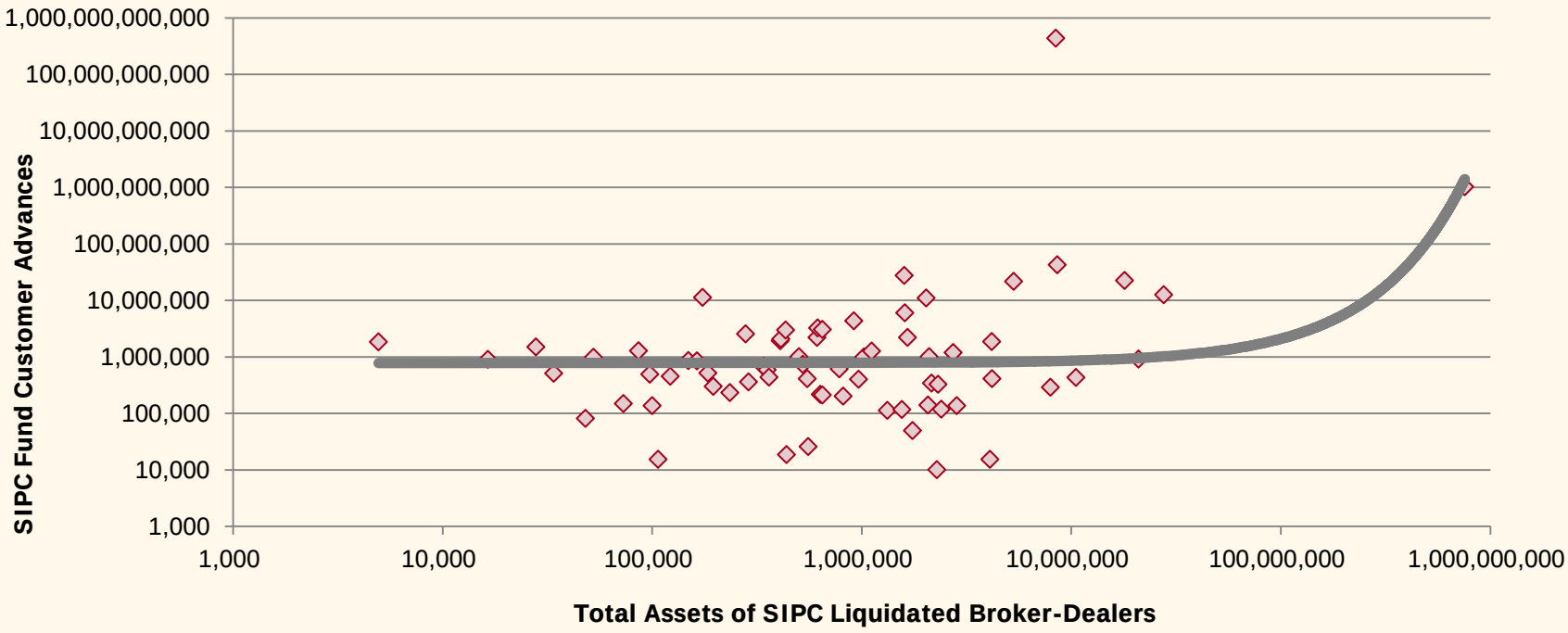
B-D Size May Not be As Correlated with Risk To Customers as we Might Expect



Scope: Comparison of customer advances paid by the SIPC Fund to the total assets of the 77 brokers and dealers subject to liquidation under the Securities Investor Protection Act (commenced after January 1, 1995 and paid as of December 31, 2010).

Source: Payment data obtained from SIPC. Information on total assets obtained from the FINRA FOCUS Reports filed by the 77 brokers and dealers prior to their liquidation under the Securities Investor Protection Act. Analysis performed by the Office of Research and Analysis.

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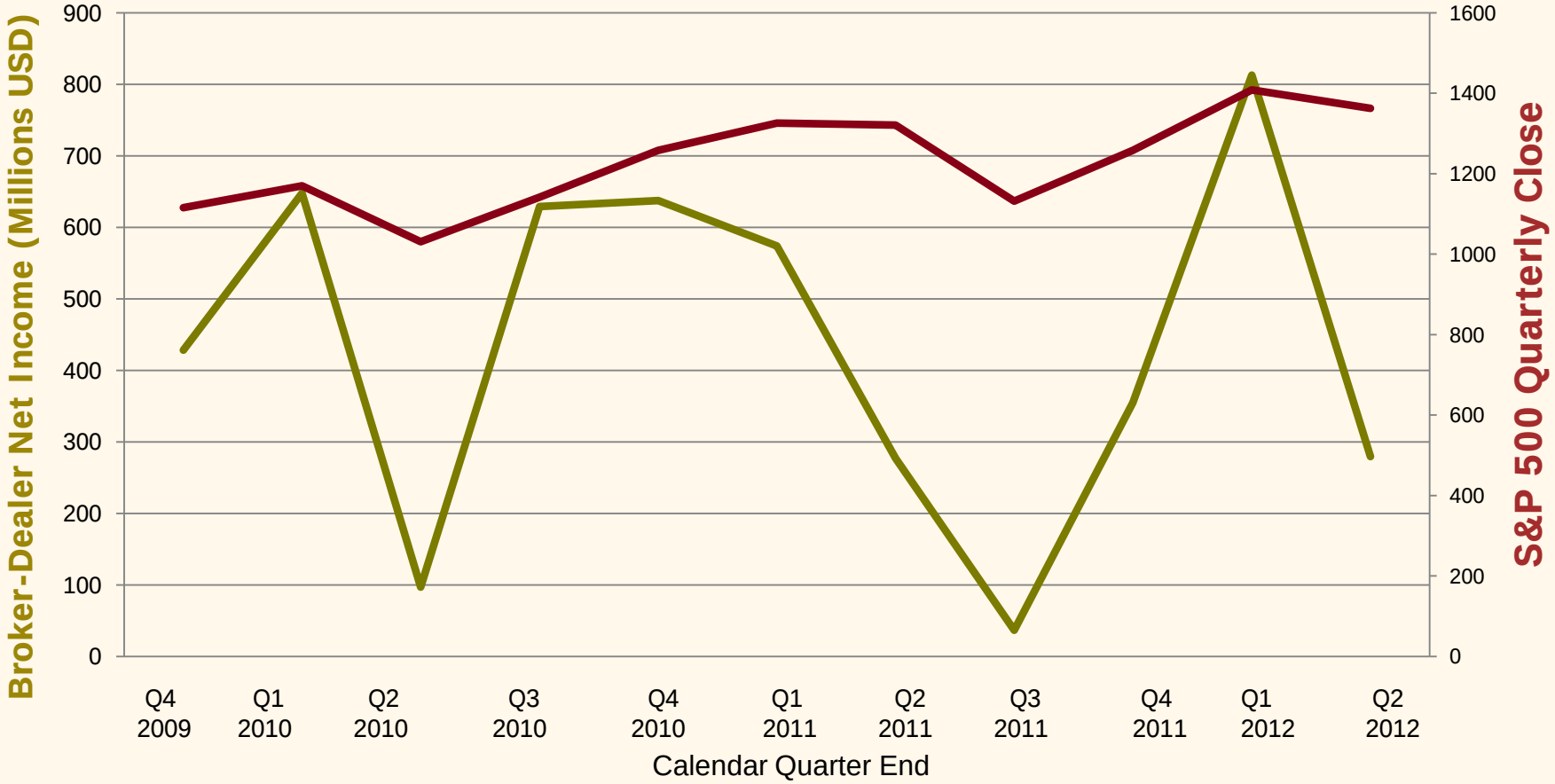
Who is to Blame in the SIPC Liquidation Population from 1995 – 2010?

Source: Information on the misconduct obtained from the trustee's final report filed with the respective bankruptcy court for the 77 brokers and dealers subject to liquidation under the Securities Investor Protection Act (commenced after January 1, 1995 and paid as of December 31, 2010). Analysis of the final trustee's final report performed by the Office of Research and Analysis.

III. Financial Trends for Brokers-Dealers audited by Smaller Audit Firms (Firms not subject to annual inspections by the PCAOB)

Comparison of Cumulative Pretax Income of B-Ds, Excluding those Audited by Annual Firms, to S&P 500 Quarterly Close



Source: Information on net income reported for the periods ending December 31, 2009 through June 30, 2012 obtained from the FINRA FOCUS Reports filed by brokers and dealers that are audited by smaller audit firms registered with the PCAOB. Information on the S&P 500 Index obtained from Capital IQ.

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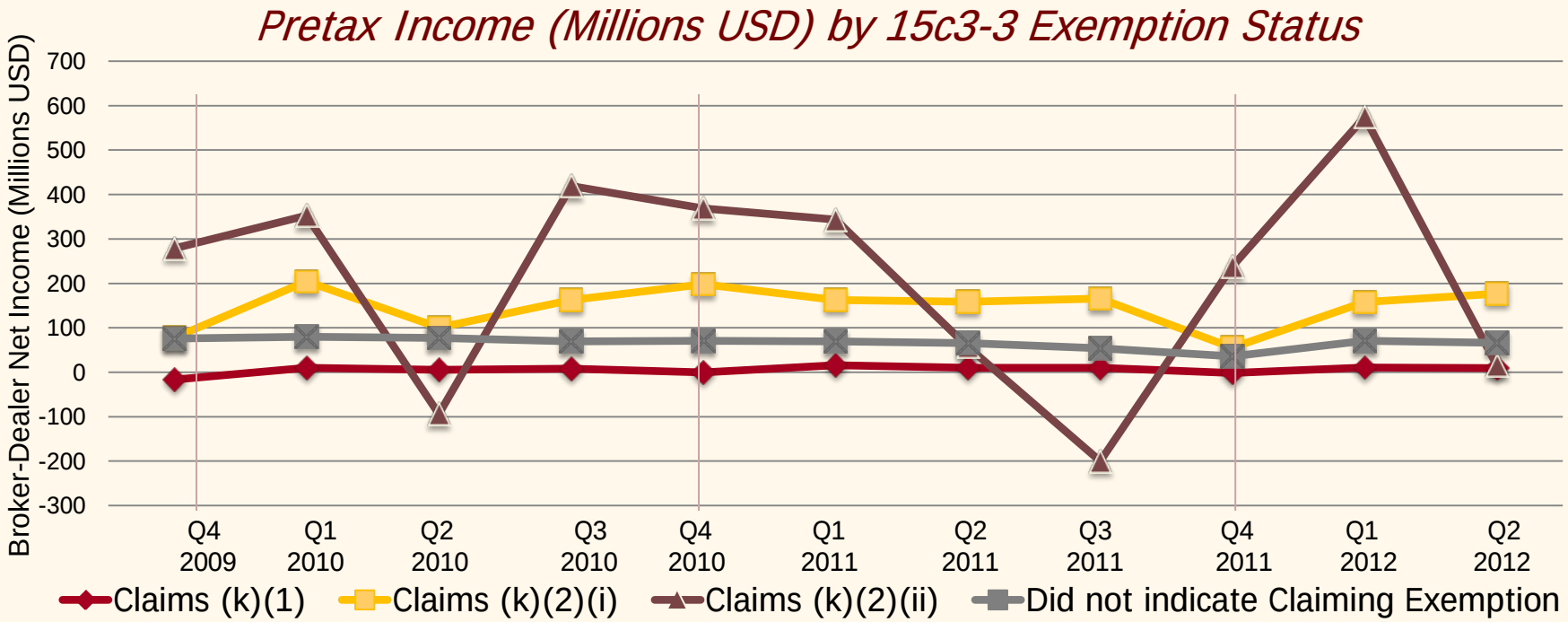
Cumulative Pretax Income of B-Ds Excluding those Audited by Annual Firms



Mutual Funds and Variable Annuities Transactions Only

Special Account for exclusive benefit of customers maintained

Introduce on a fully disclosed basis

Rule 15c3-3 Computing: Often carrying B-Ds

Source: Information on net income reported for the periods ending December 31, 2009 through June 30, 2012 and the Securities Exchange Act Rule 15c3-3 exemption status obtained from the FINRA FOCUS Reports filed by brokers and dealers that are audited by smaller audit firms registered with the PCAOB.

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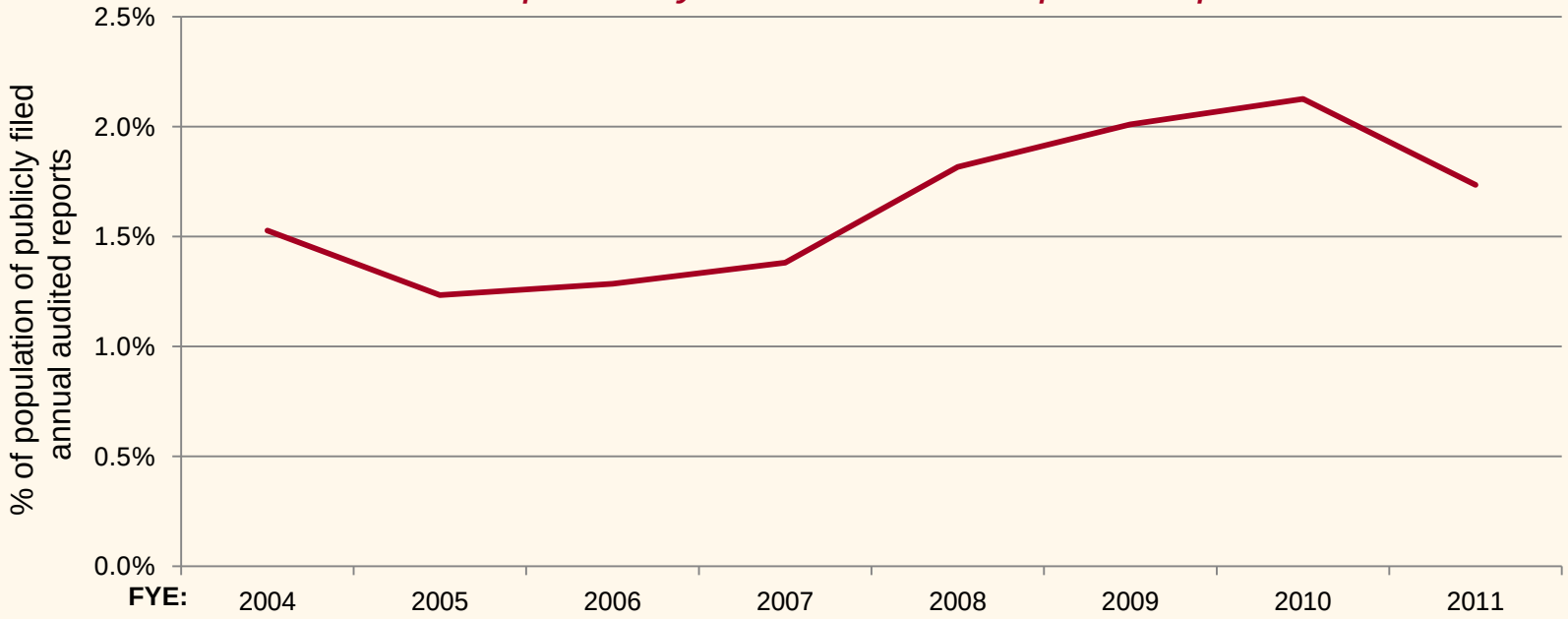
Going Concern Rates for Broker-Dealers Excluding those Audited by Annual Firms

As reported by data vendor from public reports



	2004	2005	2006	2007	2008	2009	2010	2011
Going Concern Mod. :	60	46	51	54	70	75	77	61
Annual Audited Reports:	3,928	3,729	3,967	3,909	3,854	3,731	3,622	3,515

Source: Information on going concern modifications to the audit report issued for the fiscal years ended December 31, 2004 through December 31, 2011 obtained from Audit Analytics. These audit reports for the fiscal year ended December 31, 2004 through December 31, 2011 were issued for brokers and dealers by smaller audit firms.

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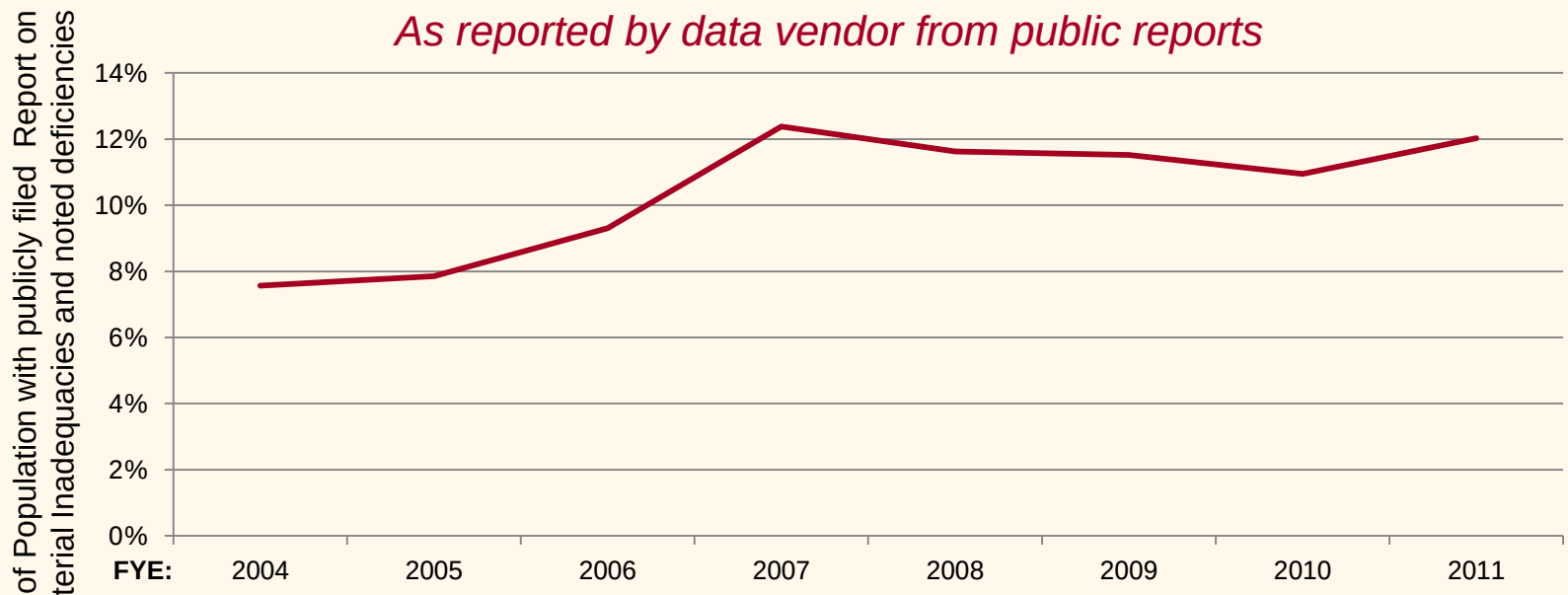
Deficiencies Noted on Rule 17a-5 Accountant's Supplemental Report on Material Inadequacies, Excluding those by Annual Firms



FYE:	2004	2005	2006	2007	2008	2009	2010	2011
Deficiencies:	224	223	279	372	341	328	295	302
Annual Audited Reports (with public supplemental report on material inadequacies):	2,962	2,841	2,998	3,005	2,934	2,848	2,694	2,512

Source: Information on deficiencies (including material inadequacies, material weaknesses, significant deficiencies, and other deficiencies) identified in publicly filed accountant's supplemental report on material inadequacies for the fiscal years ended December 31, 2004 through December 31, 2011 obtained from Audit Analytics. These audit reports for the fiscal year ending December 31, 2004 through December 31, 2011 were issued for brokers and dealers by smaller audit firms.

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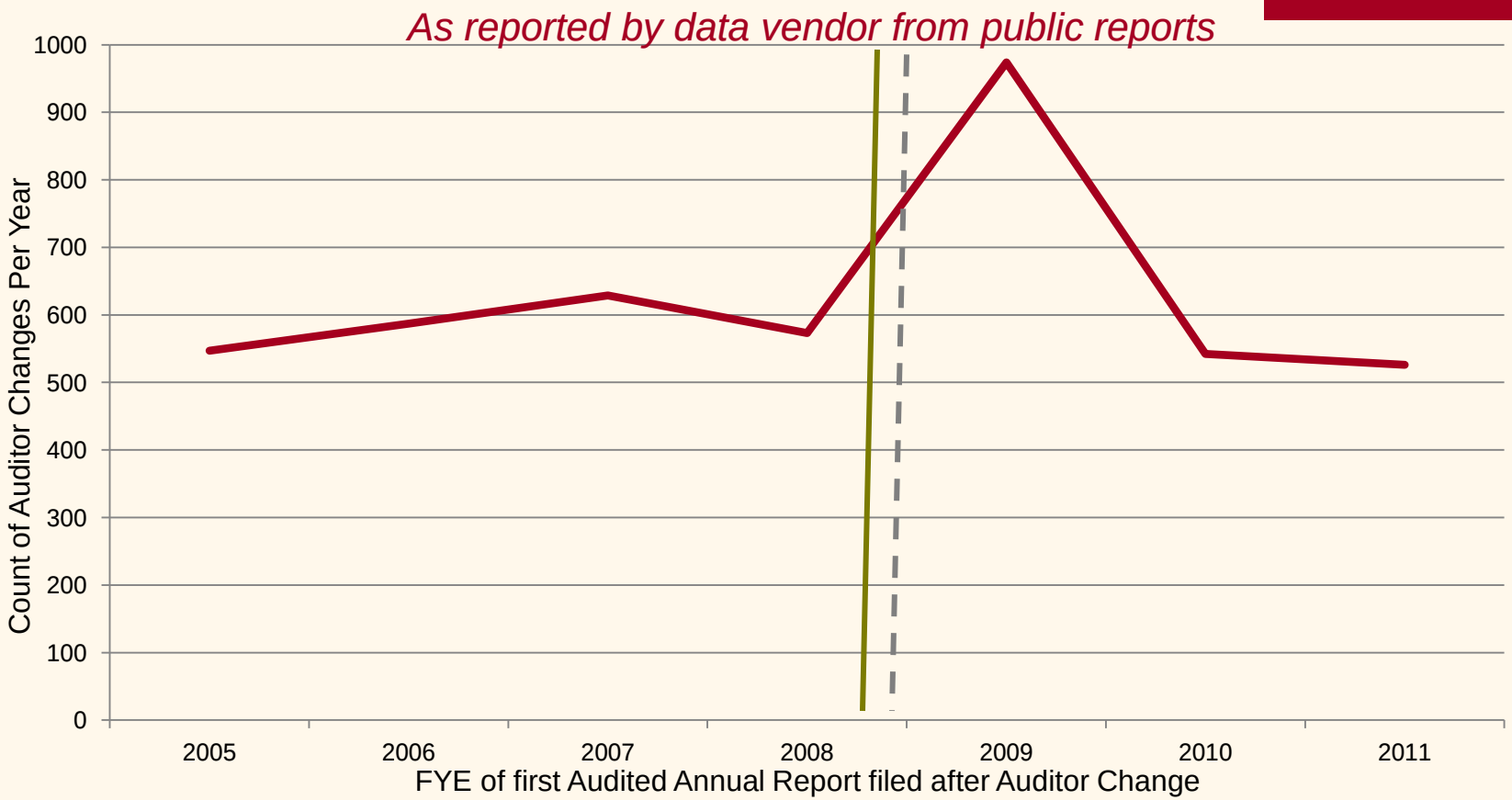
Count of Auditor Changes: *Auditing B-Ds in a Post-Madoff Environment is Different*



December 11, 2008 - The date that the SEC charged Bernard Madoff and his investment firm with securities fraud.

December 31, 2008 - Broker-dealers whose fiscal year ended after December 31, 2008, were required to comply with the section of Sarbanes-Oxley Act of 2002 requiring their financial statements to be audited by a PCAOB-registered accounting firm.

Scope: Information on the change of auditors identified from the publicly filed audited annual reports for brokers and dealers for fiscal years ended December 31, 2004 through December 31, 2011 obtained from Audit Analytics.

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Questions?

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PCAOB Overview

Mary M. Sjoquist, Director,
Office of Outreach and
Small Business Liaison
October 25, 2012
Jersey City, NJ

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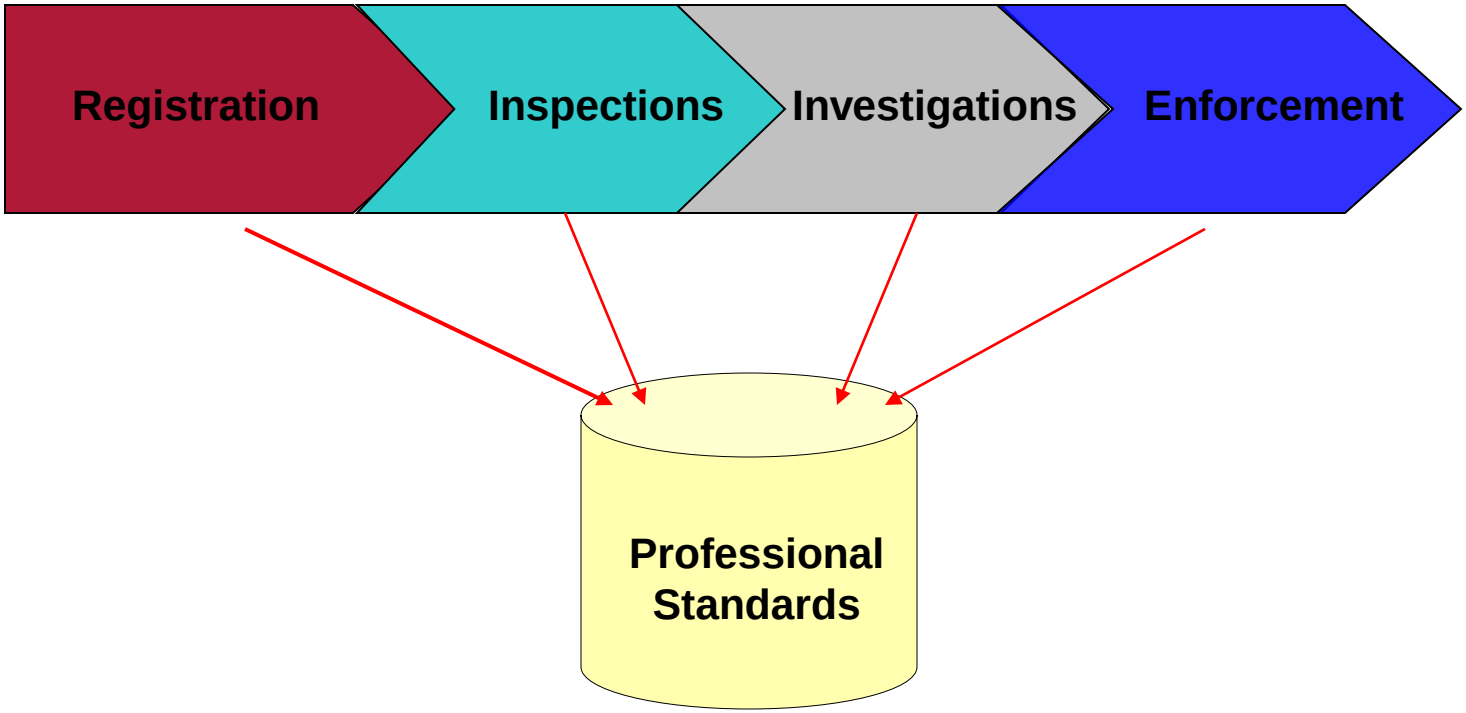
Mission Statement

- The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. The PCAOB also oversees the audits of broker-dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection.

The PCAOB in a Nutshell



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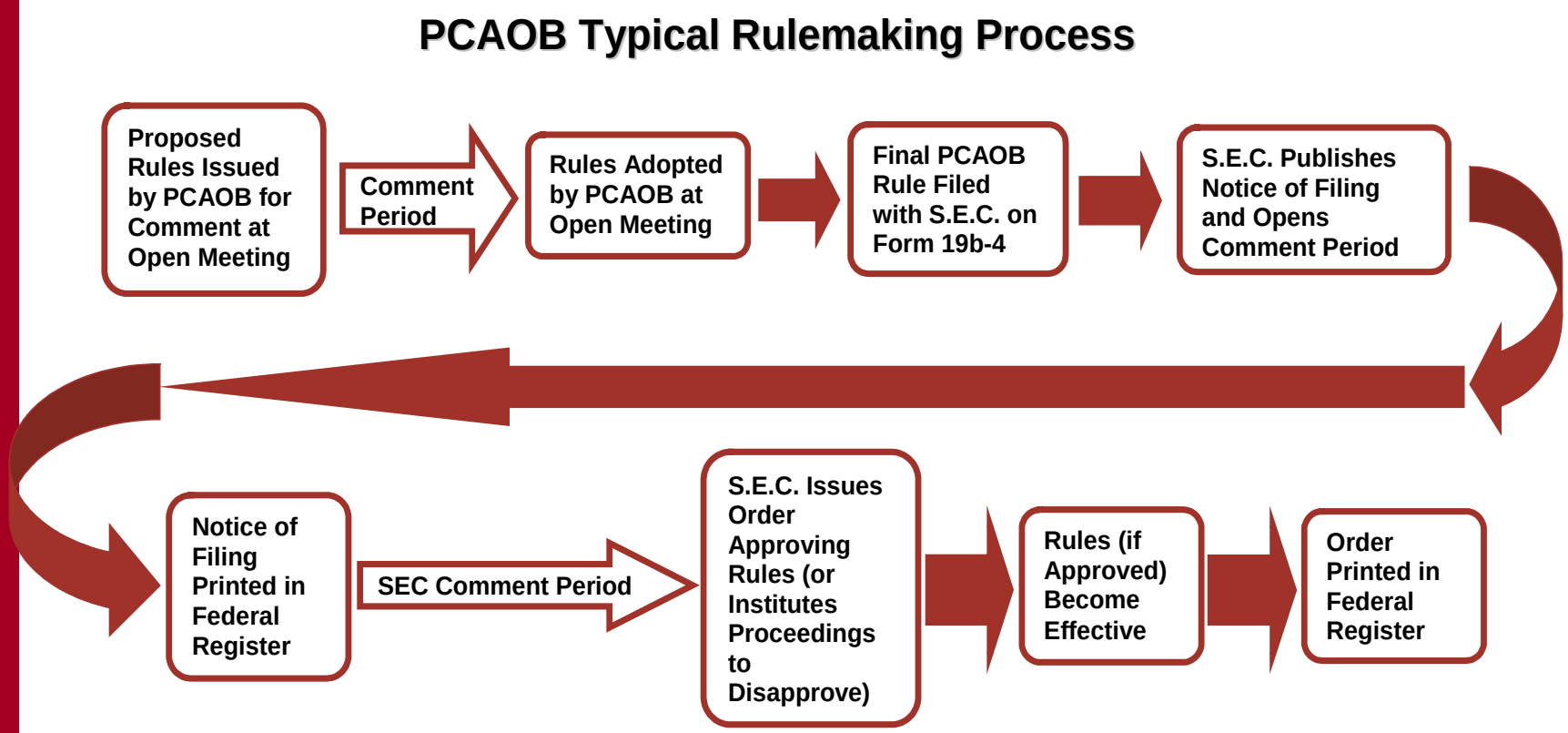
PCAOB's Standard-Setting Process



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Other Steps in Standard-Setting

- Standing Advisory Group input
- Investor Advisory Group input
- Roundtables
- Outreach to individuals and entities with interest in the subject matter
- Concept releases
- Reproposals

Pre-Dodd-Frank

- Sarbanes-Oxley provided that BD financial statements be audited by a registered firm
- SEC provided an exemption from this requirement
- This exemption expired at the end of 2008; thus, after this date, BD's financial statements were required to be audited by a PCAOB-registered firm
- Dodd-Frank extended PCAOB's authority to include oversight of auditors of BDs

Office of Outreach and Small Business Liaison

- Established on December 15, 2010
- Formalized and centralized currently existing small business initiatives
  - Small business forums
  - Outreach to smaller firms and issuers
- New functions
  - Outreach to the broker-dealer community including forums for auditors of broker-dealers
  - Central point of contact for:
    - questions about the Board's activities
    - identifying areas where information related to the Board's work is not well understood
    - suggesting actions to address these areas

Office of Outreach Contact Information

- Outreach@PCAOBUS.ORG
- 202-591-4135

Dodd-Frank--Funding

- The Act provides that the Board must allocate the accounting support fee equitably among not only issuers but also brokers and dealers (see section 109(d))
- The Board may establish different classes of issuers and of brokers and dealers for funding purposes (sections 109(g) and 109(h)(2))
- The amount due from a broker or dealer must be in proportion to the net capital of the broker or dealer (before or after any adjustments), compared to the total net capital of all brokers and dealers (before or after any adjustments), in accordance with the rules of the Board (see section 109(h)(3))

Funding Rule

- As adopted, fee is based on “tentative net capital,” which under the SEC’s Rules is net capital before deducting certain securities haircuts and charges for certain commodities transactions (see SEC Rule 15c3-1(c)(15)).
- A class of brokers and dealers, each with average quarterly tentative net capital $5 million or less, will be allocated an ASF of zero.
  - Represents 86% of FINRA registered brokers and dealers or 1.1% of the industry’s total net capital*
  - 681 of the approximately 4,600 FINRA BDs shared in payment of the 2011 fee
- Adopted by PCAOB on June 14, 2011 and approved by SEC on August 18, 2011

Funding Rule (cont'd)

- Firm may not sign an audit report; consent to the inclusion of a report; or sign a document, report, notice, or other record concerning procedures or controls of any issuer, broker, or dealer required under the securities laws for a BD with an outstanding ASF
- Limited exception where a broker or dealer needs the audit report or consent in order to submit a report to, or make a filing with, the Commission
- Under those circumstances, the auditor must provide a notice to the Board the day after the filing is made; only good for 15 days; and is a one time exception

Dodd-Frank--Inspections

- Dodd-Frank expanded the PCAOB's inspection authority to include audits of registered securities brokers and dealers.
- Gave PCAOB the authority to:
  - Differentiate among different classes of broker-dealers
  - Consider whether different inspection schedules would be appropriate with respect to auditors that issue audit reports only for brokers or dealers that do not receive, handle, or hold customer securities or cash or are not members of the Securities Investor Protection Corporation (section 104(a)(2)(B))
  - Exempt any public accounting firm from such an inspection program, the firm would not be required to register with the Board (section 104(a)(2)(D))

Temporary Inspection Rule: Interim Program

- Establish an interim program to begin inspection work on audits of broker-dealers
- Focus on assessing compliance with the rules and standards that applied at the time the audit work was done
- Pursuant to SEC Rule 17a-5, audits continue to be performed in accordance with GAAS
- Applicable rules and standards may change during this interim program if SEC proposed amendments to Rule 17a-5 requiring auditors of broker-dealers to use PCAOB standards are adopted as final rules

Temporary Inspection Rule: Interim Program

- Assist in making fully informed judgments about the scope of permanent rules
- Differentiate among classes of B-Ds
- Establish minimum inspection frequency
- Temporary inspection rule adopted by PCAOB on June 14, 2011 and approved by SEC on August 18, 2011

Interim Inspection Program Output

- Annual report on significant observations obtained during the inspections
- These reports would not be firm specific
- Identify and address with the inspected firm any significant issues in its audit work
- Where appropriate, information about potential violations by brokers or dealers would be referred to the SEC and other authorities
- May lead to an investigation or disciplinary proceedings regarding the conduct of the firm

Key Proposed Amendments to Conform PCAOB Rules and Forms to the Dodd-Frank Act

- Definition of audit committee (Rule 3501)
- Overall framework (Rules 3502 and 3520)
- Contingent fees (Rule 3521)
- Tax transactions (Rule 3522)
- Tax services for persons in a financial reporting oversight role (Rule 3523)
- Communications with audit committees concerning independence (Rule 3526)
- PCAOB independence rules applicable to auditors of issuers but not to auditors of brokers and dealers (Rules 3524 and 3525)
- Deferred compliance date for Rules 3521-3526

Rules on Periodic Reporting by Registered Public Accounting Firms--Annual Reporting

Form 2 includes –

- General information concerning the firm
- Audit clients and audit reports*
- Offices and affiliations
- Personnel
- Certain relationships
- Acquisitions
- Affirmation of consent
- Proposed amendments

*Currently only applicable to issuer reports

Rules on Periodic Reporting by Registered Public Accounting Firms--Special Reporting

Form 3 triggering events and disclosures include –

- Name change
- Audit reports (withdrawn report or consent*, or crossed 100 issuer threshold)
- Certain legal proceedings
- Bankruptcy
- Certain relationships
- Licenses and certifications
- Changes in the firm's Board contact person
- Proposed amendments

*Currently only applicable to issuer reports

Reporting Rules on Succeeding to a Predecessor Firm's Registration Status

- Allows firms whose structure has changed to retain registration status under two scenarios:
  - A registered firm changes its legal form of organization or jurisdiction in which it operates
  - A registered firm is acquired by an unregistered firm or merges with another firm to create a new legal entity

Reporting Rules on Succeeding to a Predecessor Firm's Registration Status

- The rules provide for:
  - A Form 4 must be filed within14 days after the event
  - With certain representations
- Continuity of registration is automatic, without the need for Board action:
  - A registered firm changes its legal form of organization or jurisdiction in which it operates
  - A registered firm is acquired by an unregistered firm or merges with another firm to create a new legal entity
- If deadline for filing Form 4 not met, registration process using Form 1 may be required along with Board action.

Confidential Treatment Requests

- Confidential Treatment Requests are more limited on these forms than on the registration application form
  - Board has determined that certain information will never qualify
  - In practice, this means no check box is available to request confidential treatment
- To request confidential treatment:
  - Firm must represent that information is not public AND
    - Firm must provide a detailed explanation of how the information is proprietary OR
    - Firm must provide a detailed explanation of how the information is protected from public disclosure by applicable law, and must provide a publicly available citation to or a copy of the law

Questions?

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Break

(15 minutes)

Small Broker-Dealer Business Models and Associated Risks

PCAOB Forum on Auditing Smaller Broker-Dealers - 2012

Susan DeMando Scott

Office of Risk Oversight and Operational Regulation
Financial Operations Policy Group

Financial Industry Regulatory Authority

PCAOB Findings…

- **Report on the Progress of the Interim Inspection Program Related to Audits of Brokers and Dealers.**
  PCAOB Release No. 2012-005 August 20, 2012
- **10 auditing firms / 23 broker-dealer audits.**
- **14 audits were of firms that claimed an exemption from the Customer Protection Rule.**
- **Of the 14, the minimum net capital requirement ranged from $5,000 to approximately $6 million.**
- **If the 14 audits selected align with FINRA membership statistics, several of the firms would have been $5,000 Broker-Dealers.**

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Broker-Dealer Net Capital Requirements

Minimum (Dollar) Net Capital Requirement of:

	No. of Firms	
$5,000:	2,230	49.8% of FINRA Members
$25,000 - $150,000:	1,330	29.7% *(Cumulative 79.5%)*
$250,000:	917	20.5%
Total	4,477	100%

As of June 30, 2012

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Broker-Dealer Size - by number of Registered Representatives (June 2012)

Firm Classification	"Small"	"Medium"	"Large"
Number of RR's	1 – 150	151 – 499	500+
Percentage of Firms	91.6%	4.6%	3.8%

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PCAOB Findings…

If small firms don't have complex business models, or engage in sophisticated transactions, what explains the audit issues?

- **Audit "pressures". Underestimating the cost, resources or time necessary to conduct the audit.**
- **Over-reliance on knowing the client/letting one's guard down in terms of exercising professional skepticism. (Consideration of Fraud in a Financial Statement Audit. AU Section 316. An issue in 13 of 23 audits.)**
- **Over-reliance on lack of findings and/or absence of disciplinary action by FINRA.**
- **Lack of Appreciation for Importance of Regulatory Context.**
- **Belief that annual audit requirement is perfunctory.**
- **Equating minimal capital requirements with no risk.**

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Small Broker-Dealers – Common FINRA Findings with respect to Financial Reporting Irrespective of Firm Business Model

- **Netting without adequate documentation.**
- **Confusing "off-setting" under GAAP with netting for net capital purposes.**
- **Utilizing cash-basis or a combination of accrual and cash-basis accounting.**
- **Failing to record all liabilities.**
- **Recognizing revenue before it has been earned.**
- **Valuing securities on other than (supportable) market-prices or fair value, as appropriate.**
- **Failing to recognize losses separately from any reimbursement for such losses.**
- **Not fully comprehending the financial implications of related party transactions.**
  - Expense Sharing Agreements
  - Management Services Agreements
  - Counterparty Transactions
  - Misclassified Distributions for the Benefit of Owners

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Broker-Dealers Misconceptions that have Regulatory and Financial Implications

Fiction and *Fact*:

Net Capital Requirements are static.

- ***Rule is self-operative.***
- ***Net Capital Requirement is, conceptually, ever-changing.***
- ***Not established by Firm's Membership Agreement with FINRA.***

Exemptions from Customer Protection Rule are applicable to all non-clearing and carrying firms.

- ***Exemptions are self-operative.***
- ***"Claimed" by a firm.***
- ***Claim must be supported by firm's activity or lack thereof.***

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Small Broker-Dealers – A Discussion.

To whom is the size of a small broker-dealer meaningful?

(a) The firm.

(b) The firm's regulator.

(c) The firm's customer.

(d) The firm's auditor.

And why?

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Business and Accounting Considerations with Respect to a Broker-Dealer Client

What are the business activities and operating practices of the broker-dealer? What should you expect to encounter in its accounting practices, financial statements and related disclosure?

- Does the level and composition of the firm's revenue and expense make sense given the number and activities of its employees?
- Does the level of sophistication in preparing the financial statements align with the volume and complexity of the firm's business?
- How is the broker/dealer funded? To what extent is it reliant on any particular funding source, and how might it affect management's judgment in valuing certain assets and liabilities?

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Business and Accounting Considerations with Respect to a Broker-Dealer Client

Considerations of the Accounting Environment

- Who prepares the firm's books and records?
- How long has the current arrangement existed?
- If outside Financial and Operations Principal (FinOp), how does the arrangement work in light of guidance in Notice to Members 06-23?
  - What processes are in place with respect to the preparation of the financial statements and underlying books and records?
  - Does the FinOp appear to have the necessary experience with respect to the firm's business model?
  - Does the FinOp appear to spend sufficient time at the firm?
  - On whom does the FinOp rely? Is such reliance reasonable?

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Expense Sharing Agreements (ESAs)

- **Where warranted the 2003 letter imposes "charges" in the Broker-Dealer's (B/D) Net Capital Computation.**

- **A written ESA is required anytime a parent or an affiliate *assumes responsibility for*:**
  1) **costs incurred by the B/D (i.e., B/D is obligor to 3rd party service provider) OR**
  2) **parent or affiliate incurs costs which will benefit the B/D (i.e., parent or affiliate contracts for services that will be used by the B/D (in whole or in part)).**

- **The agreement between the B/D and parent/affiliate must:**
  1) **be with a parent/affiliate which has independent financial resources from B/D,**
  2) **make clear the nature of the responsibility of each party,**
  3) **identify the costs covered by the agreement and how they arise, and**
  4) **allocate costs on a reasonable basis and in a consistent manner.**

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Expense Sharing Agreements (ESAs) - continued

When agreements are required:

Scenario 1

Parent is liable to 3rd party.

B/D expected to pay parent something.

ESA establishes BD liability to parent, and allocates cost to BD.

Scenario 2

Parent is liable to 3rd party.

B/D is expected to pay nothing to parent.

ESA establishes BD has no liability to parent, but allocates "cost" to B/D for its record keeping obligation. Points 2 and 6 of the SEC's letter. See NTM 03-63.

Scenario 3

B/D is liable to 3rd party.

Parent will pay 3rd party.

ESA establishes that parent will make payment to 3rd party, and allocates some/all of the costs back to BD. Note: B/D has obligation under GAAP to record payable to vendor until parent has made payment. B/D's ultimate cost may be adjusted downward due to allocation.

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Management Services Agreements (MSAs)

- What is an MSA?
  - An MSA describes services whereby a party (usually the B/D's parent or affiliate) provides administrative or management services to the B/D.
    - Different from an ESA. In an MSA, the parent or affiliate is providing the services. In an ESA, there is a contract with a 3rd party that provides a good or service.
  - In an MSA, we look for the following:
    - -- The parent or affiliate has the capacity to offer the service.
    - -- The BD needs the service to support its operations.
    - -- There is evidence that the services were provided to the B/D.
    - -- The costs of the services are reasonable. What would an independent 3rd party charge?
  - An MSA should not include the following:
    - -- Costs based upon the B/D's revenue/profits.
    - -- A clause providing for the automatic forgiveness of payments by the B/D if net capital issues arise.

Possible undeclared withdrawal of capital.

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Business Models and Associated Risks

Dealers

Are required to maintain $100,000 in Minimum Net Capital Requirement.

Firms do not reflect this higher requirement due to:

- **Too literal of a reading of SEA Rule 15c3-1(a)(2)(iii). Or lack of familiarity with SEC administrative proceedings.**
- **Failure to count a buy and sell (same security/same quantity) as "two" transactions.**
- **Failure to consider sales as dealer transactions when securities were received by the broker-dealer as compensation.**
- **Maintaining legitimate errors in an error account for longer than necessary – BD's capital is deemed to be subject to market risk.**
- **Deliberate attempt to obscure dealer activity by placing trades in a firm error account.**

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Business Models and Associated Risks

Dealers

A firm is a dealer (required to maintain $100,000 in Minimum Net Capital) when it engages in "principal" as opposed to "riskless principal" transactions (minimum net capital requirement of $5,000).

Firms do not reflect this higher requirement due to:

- **Failure to meet the conditions necessary to treat a transaction as riskless principal. SEA Rule 15c3-1(a)(2)(vi).**
- **The broker/dealer's view of risk being different than what the SEC provided for in the Rule.**

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Violating The Customer Protection Rule – Failure to Promptly Forward Customer Funds/Securities

Clearing and Carrying Firms are clearly subject to SEA Rule 15c3-3 (the Customer Protection Rule).

A firm that does not clear and carry must *operate* within its claimed exemption, or it will become subject to the Rule.

Violations of a claimed exemption are not uncommon.

Violations usually – but not always – arise from the failure to promptly forward customer funds and/or securities.

Common reasons firms fail to achieve prompt forwarding:

1) **Too many "handoffs" / persons/locations handling customer assets**
2) **Lack of a regulatory rationale for process**
3) **Lack of safeguards for customer assets**

In general, results in a violation of SEA Rule 15c3-3.

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Broker-Dealers Subjects to a SIPC Proceeding

Reason for Firm's Demise

52% - Unauthorized Trading

44% - Conversion of Customer Assets

4% - Other

Application of Customer Protection Rule

84% of the firms claimed an exemption

Data relates to proceedings commencing January 1, 1993 through August 31, 2012

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Broker-Dealer participates in the Sale of Securities in a Contingent Offering

Per SEA Rule 15c2-4(b)(1), a Clearing and Carrying Firm:

- May open up a separate bank account to hold customer funds until contingency is met
- May act as agent or trustee

Per SEA Rule 15c2-4(b)(2), all other Broker-Dealers:

- Must open up a separate bank *escrow* account to hold customer funds until contingency is met
- Must obtain the written agreement of the bank that the bank will act as escrow agent

In both instances:

- Account must be opened with a "bank" as defined in '34 Act, Section 3(a)(6)
- Such bank must also be unaffiliated with B/D and/or issuer
- Separate accounts are required for each offering
- Customer funds must be promptly forwarded into such account
- Broker-Dealer must ensure customer funds are remitted to issuer only when the minimum contingency has been met, or funds are returned to investors if contingency is not met

See NASD Notice to Members 84-7

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Broker-Dealer facilitates Secondary Market Transactions of Direct Participation Programs

Not considered an offering of securities.

Securities are considered to change hands when the issuer accepts the purchaser as an investor in the DPP. Funds can then be remitted to the seller to complete the transaction.

Arrangements to facilitate settlement:

- **A clearing and carrying firm may handle the transaction for the benefit of its own (not introduced) customer.**
- **A firm that claims a (k)(2)(i) exemption from the Customer Protection Rule may clear, as long as it utilizes a properly established Special Account.**
- **A fully disclosed introducing firm (i.e. one that claims a (k)(2)(ii) exemption) may engage in such transactions if its clearing firm has agreed to settle the transaction. NOTE: Frequently, clearing and carrying firms are not willing to do so.**
- **A firm establishes a separate bank escrow agreement as described in, but not required by SEA Rule 15c2-4(b)(2).**

See NASD Notice to Members 91-69

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Small Broker-Dealer Business Models and the Safeguarding of Customer Assets

In summary…

(1) **Firms must comply with the Customer Protection Rule, or one of its Exemptions and/or the language or spirit of SEA Rule 15c2-4, and 10b-9 where applicable.**

(2) **In the absence of proper arrangements, a firm could become subject to the Customer Protection Rule.**

(3) **Improper arrangements can increase a broker-dealer's net capital requirement to $250,000.**

(4) **Holding customer funds or securities usually requires registration with the SEC as a broker-dealer.**

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Financial and Operational Interpretations

- **Interpretations to SEC's Financial and Operational Rules can be found on finra.org**

- **http://www.finra.org/Industry/Regulation/Guidance/FOR/**

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Sources

SEC Cases:

Fox & Company Investments, Inc. October 31, 2005

http://www.sec.gov/news/digest/dig103105.txt

Allen Douglas Securities, Inc. October 12, 2004

http://www.sec.gov/litigation/opinions/34-50513.htm

Harrison Securities, Inc. October 29, 2004
http://www.sec.gov/litigation/aljdec/34-50614.htm

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Financial and Operational Considerations

Questions?

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PCAOB Forum for Auditors of Smaller Broker Dealers

Cecil Mak
Professional Accounting Fellow

Office of the Chief Accountant
U.S. Securities and Exchange Commission

October 25, 2012
Jersey City, NJ

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. Therefore, the views expressed today are my own, and do not necessarily reflect the views of the Commission or the other members of the staff of the Commission.

Agenda

- **Broker-Dealer Rulemaking**
  - **Current SEC Annual Reporting Requirements**
  - **Proposed Amendments to SEC Annual Reporting Requirements**
  - **Selected Areas of Public Comment**
  - **Broker-Dealer Audit Considerations**
- **Applicability of Auditor Independence Rules to Broker-Dealer Audits**

Current SEC Annual Reporting Requirements

- **Broker-dealers are required to file an annual report with the SEC and the broker-dealer's designated examining authority pursuant to Rule 17a-5**
  - **Annual report must contain audited financial statements and certain supporting schedules and supplemental reports, as applicable**
  - **The audit is conducted in accordance with GAAS, (i.e., not PCAOB standards)**

Current SEC Annual Reporting Requirements

- **Report on internal controls**
  - **The auditor is required to obtain *reasonable assurance* that any material inadequacies existing at the audit report date in the following areas are disclosed:**
    - **Accounting system**
    - **Internal control**
    - **Procedures for safeguarding securities, and**
    - **Practices and procedures specified by Rule 17a-5**
  - **Study of practices and procedures followed, including consideration of control activities for safeguarding securities**
  - **Broker-dealers that are exempt from Rule 15c3-3**

Proposed Amendments to SEC Annual Reporting Requirements

- **In addition to existing requirements to file audited financial statements and certain supporting schedules ("Financial Report"), proposed Rule 17a-5 would also require the following new reports:**
  - ***Carrying*** **broker-dealer**
    - **Compliance Report**
    - **Examination Report of independent public accountant**
  - ***Non-carrying*** **broker-dealer**
    - **Exemption Report**
    - **Review Report of independent public accountant**

Proposed Amendments to SEC Annual Reporting Requirements

- **Audit of the Financial Report, the examination of the Compliance Report and the review of the Exemption Report would be conducted in accordance with PCAOB standards, instead of GAAS**
- **Examples of PCAOB standards containing additional requirements compared to GAAS include, but are not limited to:**
  - **Auditing Standard No. 3, *Audit Documentation***
  - **Auditing Standard No. 7, *Engagement Quality Review***

Proposed Amendments to SEC Annual Reporting Requirements

- ***Carrying*** **broker-dealer required to file a Compliance Report which would include management's written assertions of whether:**
  - **It was in compliance in all material respects with the Financial Responsibility Rules as of its fiscal year-end;**
  - **The information used to assert compliance was derived from the books and records of the broker-dealer; and**
  - **Internal control over compliance with the Financial Responsibility Rules was effective *during* the most recent fiscal year such that there were no instances of material weakness.**

Proposed Amendments to SEC Annual Reporting Requirements

- ***Carrying*** **broker-dealer could not assert compliance with the Financial Responsibility Rules if it identifies one or more instances of material non-compliance**
- ***Carrying*** **broker-dealer would be required to engage an independent public accountant to:**
  - **Prepare an Examination Report based on an examination of the broker-dealer's assertions contained in the Compliance Report**

Proposed Amendments to SEC Annual Reporting Requirements

- **Material non-compliance**
  - **A failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules in all material respects**
- **Material weakness**
  - **A deficiency, or a combination of deficiencies, in internal control over compliance with the Financial Responsibility Rules, such that there is a reasonable possibility that material non-compliance with those provisions will not be prevented or detected on a timely basis**
- **Existing term "material inadequacy" replaced**

Proposed Amendments to SEC Annual Reporting Requirements

- ***Non-carrying*** **broker-dealer would be required to:**
  - **File an Exemption Report to assert that it is exempt from the provisions of Rule 15c3-3**
  - **Engage an independent public accountant to prepare a report based on a review of the broker-dealer's assertion that it is exempt from the provisions of Rule 15c3-3 contained in the Exemption Report**

Proposed Amendments to SEC Annual Reporting Requirements

- **Proposed requirement for independent public accountant to notify the Commission, within one business day, if instance of "material non-compliance" exists with respect to the Financial Responsibility Rules**

Proposed Amendments to SEC Annual Reporting Requirements

- **Proposed access to audit documentation**
  - ***Clearing*** **broker-dealer would consent to permitting its independent public accountants to:**
    - **Make available to the Commission and Designated Examining Authority ("DEA") examiners the audit documentation associated with its annual reports required under Rule 17a-5**
    - **Discuss findings relating to the audit reports with the Commission and DEA examiners**
- **Proposed new Form Custody**

Selected Areas of Public Comment

- **Comment period closed on August 26, 2011**
  - **27 comment letters received**
- **Areas of public comment included:**
  - **Effective date and transition period**
  - **Material non-compliance and material weakness**
  - **Reporting of remediation of material weaknesses**
  - **Relationship between internal control over compliance with Financial Responsibility Rules and internal control over financial reporting**
  - **Period or "as of date" exemption of Rule 15c3-3**
  - **Notification requirements to the Commission**

Broker-Dealer Audit Considerations

- **Sept. 24, 2010 – Commission published interpretive guidance to clarify the application of certain rules, regulations, releases, and staff bulletins in light of the PCAOB's oversight**

- **Nov. 18, 2010 – Letter issued by SEC Director of Trading and Markets and SEC Chief Accountant concerning requirements for broker-dealer annual audits pursuant to Rule 17a-5**

Applicability of Auditor Independence Rules to Broker-Dealer Audits

Applicability of Auditor Independence Rules to Broker-Dealer Audits

- **Auditors of both issuer and non-issuer broker-dealers are required to be qualified and independent in accordance with the Commission's auditor independence requirements in Rule 2-01 of Regulation S-X, *Qualification of Accountants***

Applicability of Auditor Independence Rules to Broker-Dealer Audits

- **Examples of applicable independence requirements:**
  - **Non-Audit Services – An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides, among others, the following non-audit services to an audit client:**
    - **Bookkeeping or Other Services Related to the Accounting Records or Financial Statements of the Audit Client.**
    - **Management Functions**
  - **Other Financial Interests in Audit Client**

Applicability of Auditor Independence Rules to Broker-Dealer Audits

- **Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions**
  - **Auditors of non-issuer brokers-dealers are not subject to rules related to:**
    - **Partner rotation requirements**
    - **Certain partner compensation arrangements**
- **Auditors of non-issuer broker-dealers are also not subject to rules related to:**
  - **Audit committee administration requirements**
  - **"Cooling off" period requirements**

Contact Information

- **Office of the Chief Accountant Involvement in Auditor Independence Matters**
  - **Professional Practice Group – Independence**
    - **Phone: (202) 551-5300**
    - **E-mail : OCA@sec.gov**

- **Subscribe to receive SEC updates by e-mail:**
  - **http://sec.gov/news/press/subscribe_updates.htm**

Questions?

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Results of Inspections of Audits of Brokers and Dealers and Related Standards

Bob Maday and Kate Ostasiewski,
Division of Registration and Inspections

Barbara Vanich,
Office of Chief Auditor

Agenda

- Introduction and Background
- Overview of Annual Progress Report
- Inspection Observations
- Summary

Objectives of the Interim Inspection Program

- Assess compliance with applicable Board and Commission rules and professional standards
- Help inform the Board's eventual determinations about the scope and elements of a permanent inspection program, including
  - Whether and how to differentiate among classes of brokers and dealers
  - Whether to exempt any category of registered public accounting firm
  - Establishment of minimum inspection frequency schedules

Interim Inspection Program Plan

- Plan to perform inspections of approximately 100 registered public accounting firms covering portions of more than 170 audits by the end of 2013
  - Cross section of registered firms
  - Cross section of brokers and dealers

- Inspections during 2012
  - Approximately 40 firms and portions of 60 audits

Inspection Process

- Communication and scheduling with the registered public accounting firm
- Inspection of audit work
- Information gathering
- Communication of findings/observations
- Firm response to findings and responsibilities under AU 390
- Reporting

Responsibility under AU 390

- As part of the response, the Firm should document their planned remedial actions
- Consider AU 390 *Consideration of Omitted Procedures After the Report Date*
- The PCAOB will evaluate responses

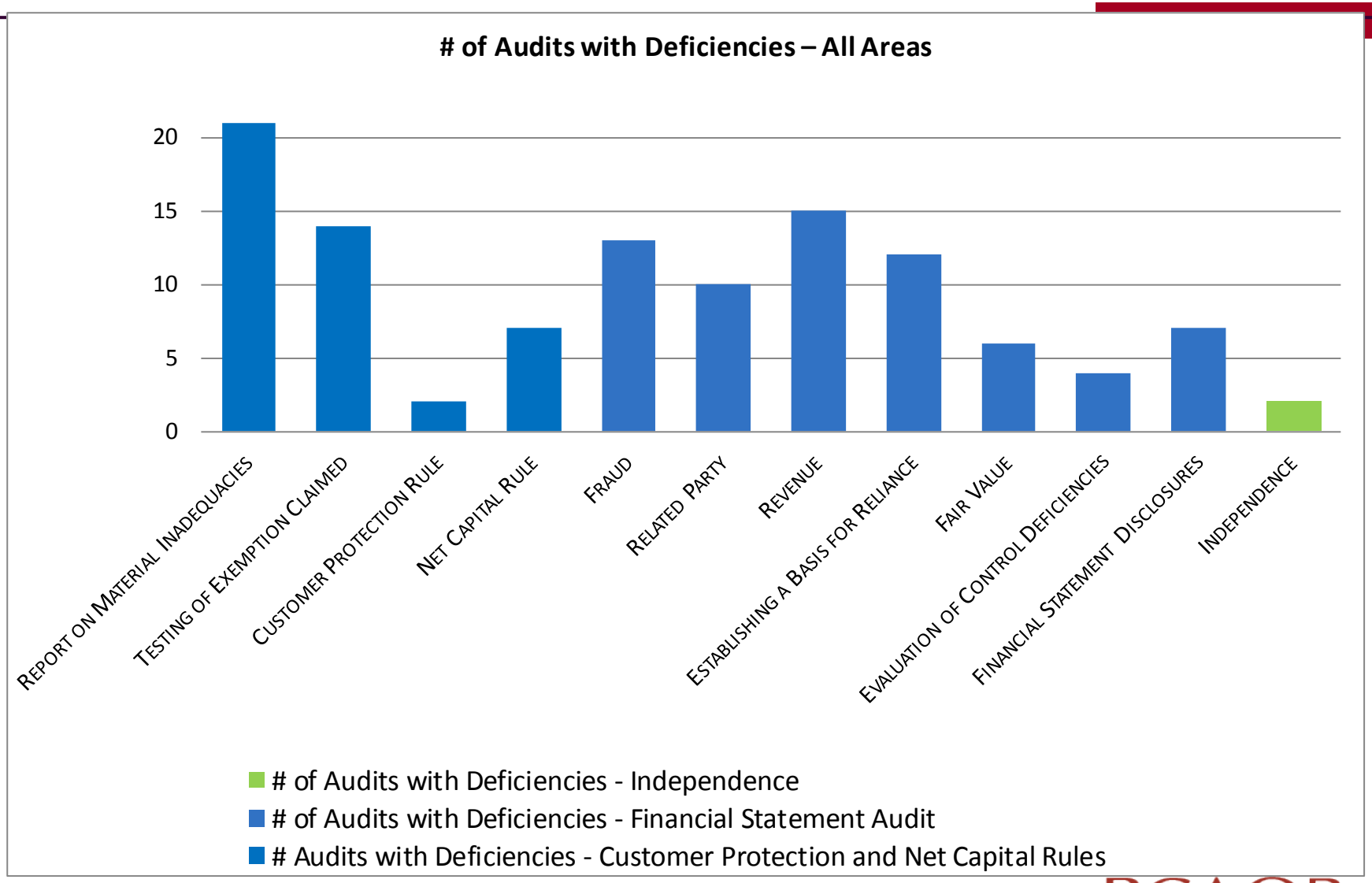
Reporting

- Annual progress report
- Do not plan to issue firm-specific inspection reports under the Interim Inspection Program
- Findings identified during the Interim Inspection Program may be included in reports issued under the permanent program, if the firm remains subject to inspection
- May lead to an investigation or disciplinary proceedings regarding the conduct of the firm
- Where appropriate, information about potential violations by brokers and dealers of any statute or rule administered by the SEC, would be referred to the SEC and other authorities

Annual Progress Report

- First report issued on August 20, 2012
- Part I – Overview of Rules and Reporting Requirements
- Part II – Inspections of Firms and Audits Selected
- Part III – Observations
  - Customer Protection and Net Capital Rules
  - Financial Statement Audit
  - Independence
- Part IV – Next Steps of the Interim Inspection Program

Inspections Observations by Audit Area



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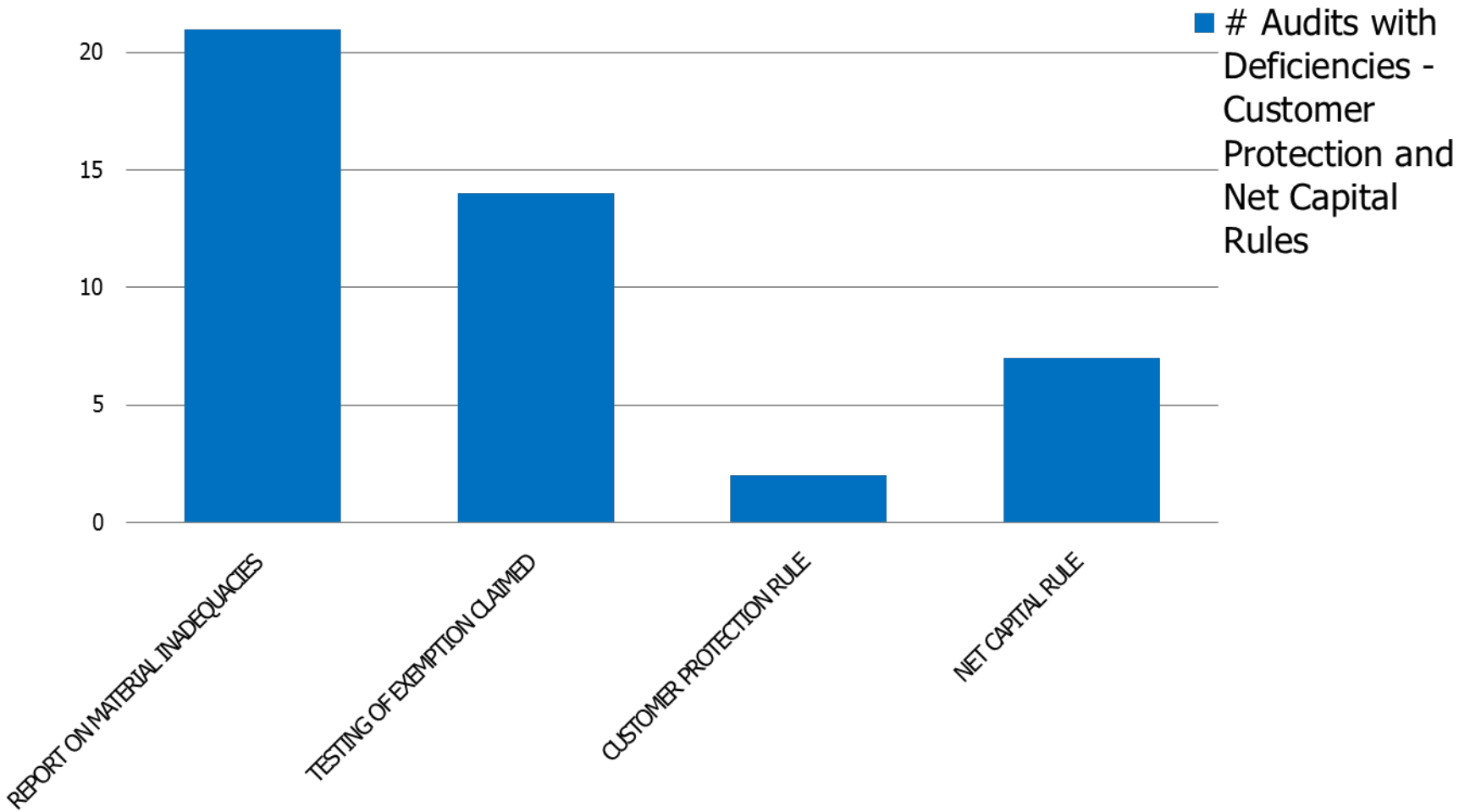
Inspections Observations:
Customer Protection and Net Capital Rules



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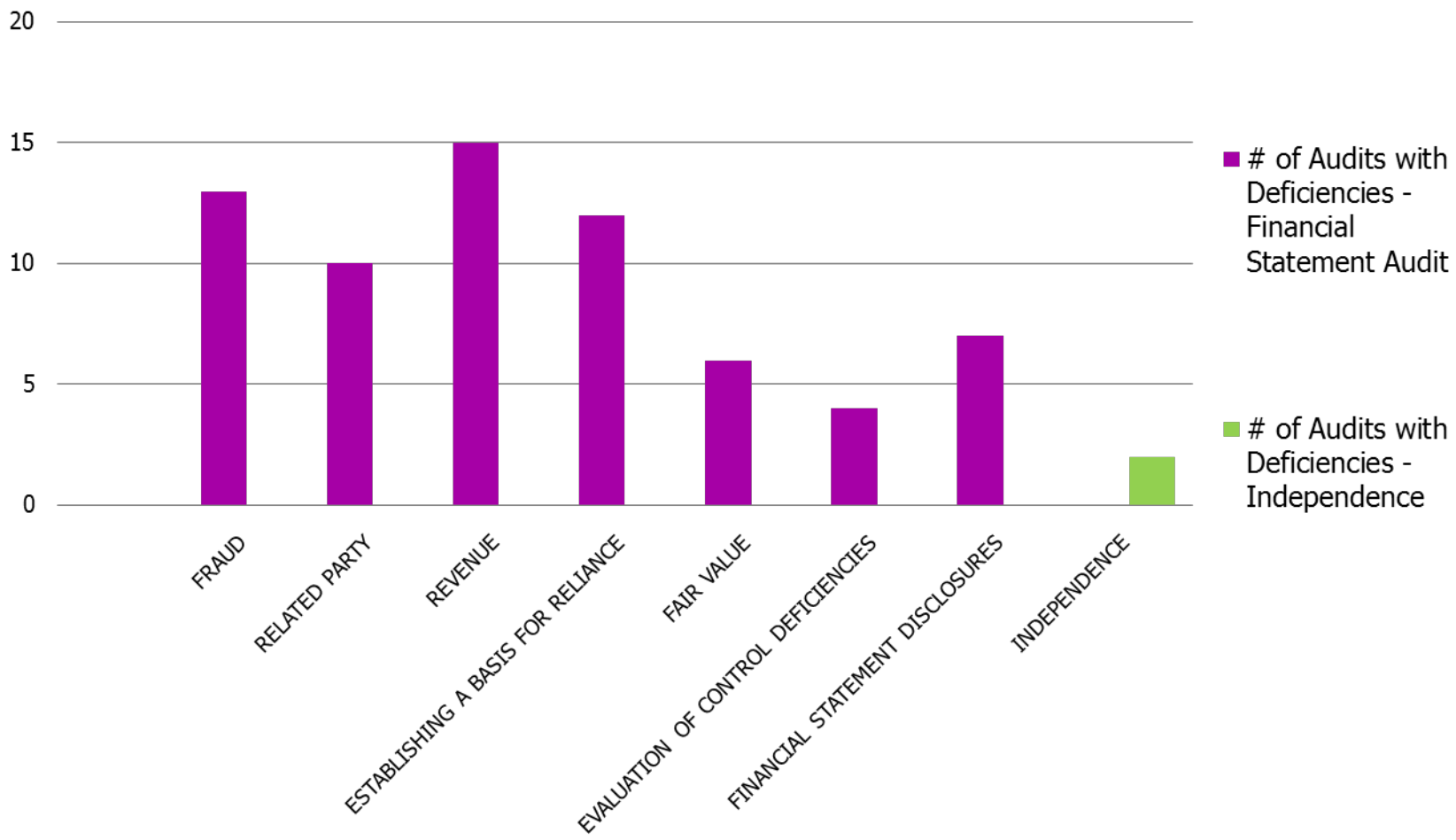
Inspections Observations:
Financial Statement Audit and Independence



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2012 Inspections Observations

- Similar observations continuing
- Emerging Observations:
  - Roll-forward procedures
  - Information Technology General Controls
- Independence

Failures to Comply with Independence Rule

Auditor Independence

PCAOB Observation

Firms failed to maintain independence in accordance with SEC rules.

- Auditors of brokers and dealers registered with the SEC are subject to SEC independence requirements in (b) and (c) of Rule 2-01 of Regulation S-X.
- SEC independence requirements differ from AICPA independence requirements

Auditor Independence

Questions:

What types of activities are permissible to perform in addition to the financial statement audit under SEC rules?

Which activities are not?

Compliance with Rule 17a-5

Rule 17a-5 Annual Reporting Requirements

Generally, brokers and dealers are required to file with the SEC, audited financial statements along with:

- Audited supporting schedules relating to:
  - The computation of net capital,
  - The computation of the customer reserve requirement, and
  - Information relating to the possession or control requirements under Rule 15c3-3

Rule 17a-5 Annual Reporting Requirements

Generally, brokers and dealers are required to file with the SEC, audited financial statements along with (cont.):

- An accountant's report on material inadequacies describing any material inadequacies found to exist or found to have existed since the date of the previous audit

Rule 17a-5 Annual Reporting Requirements

Generally, the annual reporting requirements are fulfilled by the broker or dealer by engaging an independent auditor to:

- Opine on the financial statements, which may include disclosure of net capital and other compliance information
- Issue an opinion on the supporting schedules

Rule 17a-5 Annual Reporting Requirements

Generally, the annual reporting requirements are fulfilled by the broker or dealer by engaging an independent auditor to (cont.):

- Perform an audit and review of the accounting system, the internal control and procedures for safeguarding securities sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination would be disclosed.

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Deficiencies Related to the Net Capital Rule and the Customer Protection Rule

Compliance with Net Capital Requirements

PCAOB Observation

Firms failed to:

- Sufficiently test haircuts
- Sufficiently test classification of allowable and non-allowable assets
- Ascertain whether an early warning notification was made or whether an indication of a material inadequacy existed

Compliance with Customer Protection Rule

PCAOB Observation

Where a reserve was required, firms failed to:

- Verify that the special reserve bank accounts were designated for the exclusive benefit of customers
- Test that account agreements contained the required restrictive provisions

Auditing Supporting Schedules

AU 551 ***Supplementary Information in Relation to the Financial Statements as a Whole***

.07 "In addition to the procedures performed during the audit of the financial statements, in order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should perform the following procedures using the same materiality level used in the audit of the financial statements…"

Auditing Supporting Schedules

Example #1

Broker A provides the schedules it used to calculate its haircut charges. For a sample, the auditor agrees the haircut percentage to the Rule and agrees the total inventory balance to other audit work performed.

Given the required scope of the auditor's work, what additional procedures, if any, would the auditor perform and why?

Other Compliance Matters

Example #2

Broker B has a special reserve bank account that was designated for the exclusive benefit of its customers. The auditor obtained a confirmation of the balance by receiving the bank statement directly from the bank.

Given the required scope of the auditor's work, what additional procedures, if any, would the auditor perform and why?

Other Compliance Matters

Rule 17a-5(h)(2)

"…The broker or dealer shall also furnish the accountant with a copy of said notice to the Commission by telegraphic or facsimile within said 24 hour period. If the accountant fails to receive such notice from the broker or dealer within said 24 hour period, or if the accountant disagrees with the statements contained in the notice of the broker or dealer, the accountant shall have a responsibility to inform the Commission and the designated examining authority by report of material inadequacy within 24 hours thereafter as set forth in paragraph (g) of Rule 17a-11..."

Other Compliance Matters

Example #3

Broker C notified the auditor that its net capital at the end of September had fallen to less than 120 percent of its required minimum net capital.

Is it the responsibility of the broker or the auditor to promptly send an early warning notice to the SEC and the broker's designated examining authority if this scenario occurs?

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Lunch

(60 minutes)

Audit Deficiencies Related to the Accountant's Supplemental Report on Material Inadequacies

Accountant's Supplemental Report on Material Inadequacies

PCAOB Observation

Firms failed to perform sufficient procedures to obtain reasonable assurance that material inadequacies existing as of the date of the examination were disclosed.

Accountant's Supplemental Report on Material Inadequacies

Rule 17a-5 states that:

The scope of the audit and review of the accounting system, the internal control and procedures for safeguarding securities shall be sufficient to provide **reasonable assurance** that any material inadequacies existing at the date of the examination in (a) the accounting system; (b) the internal accounting controls; (c) procedures for safeguarding securities; and (d) the practices and procedures whose review is specifies in (i), (ii), (iii) and (iv) of this paragraph would be disclosed.

Accountant's Supplemental Report on Material Inadequacies

Example #1

Auditor obtains an understanding of internal control to comply with AU 314 but excludes the effect of controls from the relevant risk assessment. Auditor performs a substantive audit to support the opinion on the financial statements.

What else does the auditor need to do to support his or her work for the MI report?

Accountant's Supplemental Report on Material Inadequacies

Example #2

Auditor performs independent tests of the net capital and reserve calculations and finds no errors. Auditor also meets with the FinOp to understand how these calculations are prepared.

Did the auditor perform sufficient procedures to obtain reasonable assurance? If not, what other procedures could be considered to enable the auditor to obtain reasonable assurance?

Accountant's Supplemental Report on Material Inadequacies

Example #3

Auditor performs independent tests of the net capital and reserve calculations and finds no errors. The capital amount and reserve deposit/balance are well in excess of the requirements (new fact). Auditor meets with the FinOp to understand how these calculations are prepared.

There are new facts in this example. How does this change the discussion that we had in the last example, if at all?

Accountant's Supplemental Report on Material Inadequacies

Example #4

Auditor performs independent tests of the net capital and reserve calculations and finds no errors. Auditor also meets with the FinOp to understand how these calculations are prepared. The FinOp indicates that the President reviews the FOCUS report prior to release.

What additional procedures, if any, did the auditor need to perform to issue the MI report?

Accountant's Supplemental Report on Material Inadequacies

Example #5

Auditor performs independent tests of the net capital and reserve calculations and finds no errors. Auditor also meets with the FinOp to understand how these calculations are prepared. The FinOp indicates that the President reviews the FOCUS report prior to release. Auditor observes the President's signature on the FOCUS report.

What additional procedures, if any, should the auditor perform to issue the MI report?

Accountant's Supplemental Report on Material Inadequacies

Example #6

Broker A uses a small package software as its general ledger and to prepare its financial statements. Auditor completed internal control questionnaire and noted that the CFO prepares all journal entries, and all are reviewed by the President.

What additional procedures, if any, should the auditor perform to obtain reasonable assurance over the accounting system and internal accounting controls?

Accountant's Supplemental Report on Material Inadequacies

- Segregation of duty issues in small brokers and dealers and less complex systems can increase risk
- IT risks can be mitigated by:
  - Conducting periodic reviews of status segregation of duties (SOD).
  - Using audit facilities of packaged software to identify suspicious activities (e.g., modifications of transaction data, transactions initiated by unauthorized individuals, deletion of transactions or transactions data)

Accountant's Supplemental Report on Material Inadequacies

Example #7

Broker B is a fully-disclosed introducing broker and claims the (k)(2)(ii) exemption under Rule 15c3-3. To ascertain whether the broker complied with the conditions of the exemption, auditor asked management whether anything had changed from the prior year. Management responded that nothing had changed.

Did the auditor perform sufficient procedures?

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Accountant's Supplemental Report on Material Inadequacies

Example #8

Broker C is a one person operation that uses a clearing firm. The majority of balances are recorded in the financial statements based on clearing firm reports. Auditor identifies that there is no segregation of duties in the accounting function.

What is the process the auditor should consider to determine whether a material inadequacy exists?

Internal Control Considerations

- Understand business process and identify “what could go wrongs”
- Identify controls to address “what could go wrongs”
- Testing design of control
  - Controls address relevant assertions
  - Controls address risk of material misstatements if operating properly
- Testing operating effectiveness of controls
  - Relevant, consistent, by whom and by what means
  - Inquiry, observation, examination of evidence, reperformance
- Evaluating control deficiencies
  - Assess severity of control deficiencies individually and in combination
  - Identify and assess mitigating controls

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Deficiencies Related to the Financial Statement Audit

Consideration of Material Misstatement Due to Fraud

PCAOB Observation

Firms failed to perform sufficient procedures to identify, assess, and respond to the risks of material misstatement due to fraud.

- Auditor should conduct engagement with mindset that the possibility that a material misstatement due to fraud could be present, regardless of any past experience and belief about management's honesty and integrity.
- Auditor should perform procedures to examine journal entries or other adjustments for evidence of possible material misstatement due to fraud

Consideration of Material Misstatement Due to Fraud

AU 316 ***Consideration of Fraud in a Financial Statement Audit***

.61 "For purposes of identifying and selecting specific entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor should consider:

The auditor's assessment of the risk of material misstatement due to fraud...

The effectiveness of controls that have been implemented over journal entries and other adjustments...

The entity's financial reporting process and the nature of the evidence that can be examined...

The characteristics of fraudulent entries or adjustments...

The nature and complexity of the accounts...

Consideration of Material Misstatement Due to Fraud

Example #1

Broker A has a relatively small general ledger. Auditor obtained a report of all journal entries and "scanned" all the entries, noting nothing unusual.

Has the auditor performed sufficient procedures to examine journal entries to address the risk of management override?

Consideration of Material Misstatement Due to Fraud

Example #2

Auditor selected 10 journal entries from the general ledger and obtained and reviewed support for the journal entries. Auditor concluded that each entry had a valid business purpose.

Has the auditor performed sufficient procedures to examine journal entries to address the risk of management override?

Related Party Transactions

PCAOB Observation

Firms did not perform sufficient audit procedures to identify the existence of related parties and material related party transactions or evaluate the purpose, nature and extent of identified related party transactions.

- Auditor should place emphasis on testing material transactions with parties known to be related to the reporting entity
- After identifying, Auditor should apply procedures necessary to obtain satisfaction concerning purpose, nature and extent of transactions

Related Party Transactions

AU 334 ***Related Parties***

.07 “The auditor should place emphasis on testing material transactions with parties he knows are related to the reporting entity. Certain relationships, such as parent-subsidiary or investor-investee, may be clearly evident. Determining the existence of others requires the application of specific audit procedures...”

Related Party Transactions

AU 334 *Related Parties*

.09 "...The auditor should apply the procedures he considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements..."

"The procedures should be directed toward obtaining and evaluating sufficient appropriate audit evidence and should extend beyond inquiry of management."

NASD Notice to Members 03-63, Expense-Sharing Agreements

http://www.finra.org/Industry/Regulation/Notices/2003/P003100

Related Party Transactions

Example #1

Broker B has not disclosed any related parties or related party transactions. Auditor has no reason to suspect that related party transactions or control relationships exist at the broker. Auditor obtained management's representation that there were no related parties or related party transactions.

What additional procedures, if any, should the auditor perform to determine the existence of related parties and identify related party transactions?

Related Party Transactions

Example #2

Broker C has an expense-sharing agreement with its parent. Auditor obtained and read the expense-sharing agreement. Auditor verified that all payments made by the broker to the parent were made for expenses identified in the expense-sharing agreement.

Has the auditor performed sufficient procedures to examine identified related party transactions?

Related Party Transactions

Example #3

An expense-sharing agreement states that Broker D will pay its parent $25,000 every month for "management services and other administrative services." The written agreement does not further define the services. Broker D does not record any expenses such as rent, utilities, telephone, etc., and management says that all such expenses are included in the $25,000 per month fee. Auditor agreed year-end balance of Broker D's allocated expenses and related payable to the Parent's trial balance.

What additional procedures, if any, should the auditor perform with respect to the expense-sharing agreement and the allocated expenses?

Revenue Recognition

PCAOB Observation

Firms did not perform sufficient audit procedures to:

- Test revenue recognition
- Test all material classes of revenue transactions
- Verify commission rates

Revenue Recognition

AU 318 ***Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained***

.51 Regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. This reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement.

Revenue Recognition

Example

Broker A has revenue of $11 million, which is comprised of commission revenue of $10 million and principal transactions revenue of $1 million. Planning materiality was established as $50,000. Auditor tests commission revenue, but does not perform tests of principal transactions revenue.

What else, if anything, does the auditor need to do to sufficiently test the revenue balance?

Establishing a Basis for Reliance on Records and Reports

PCAOB Observation

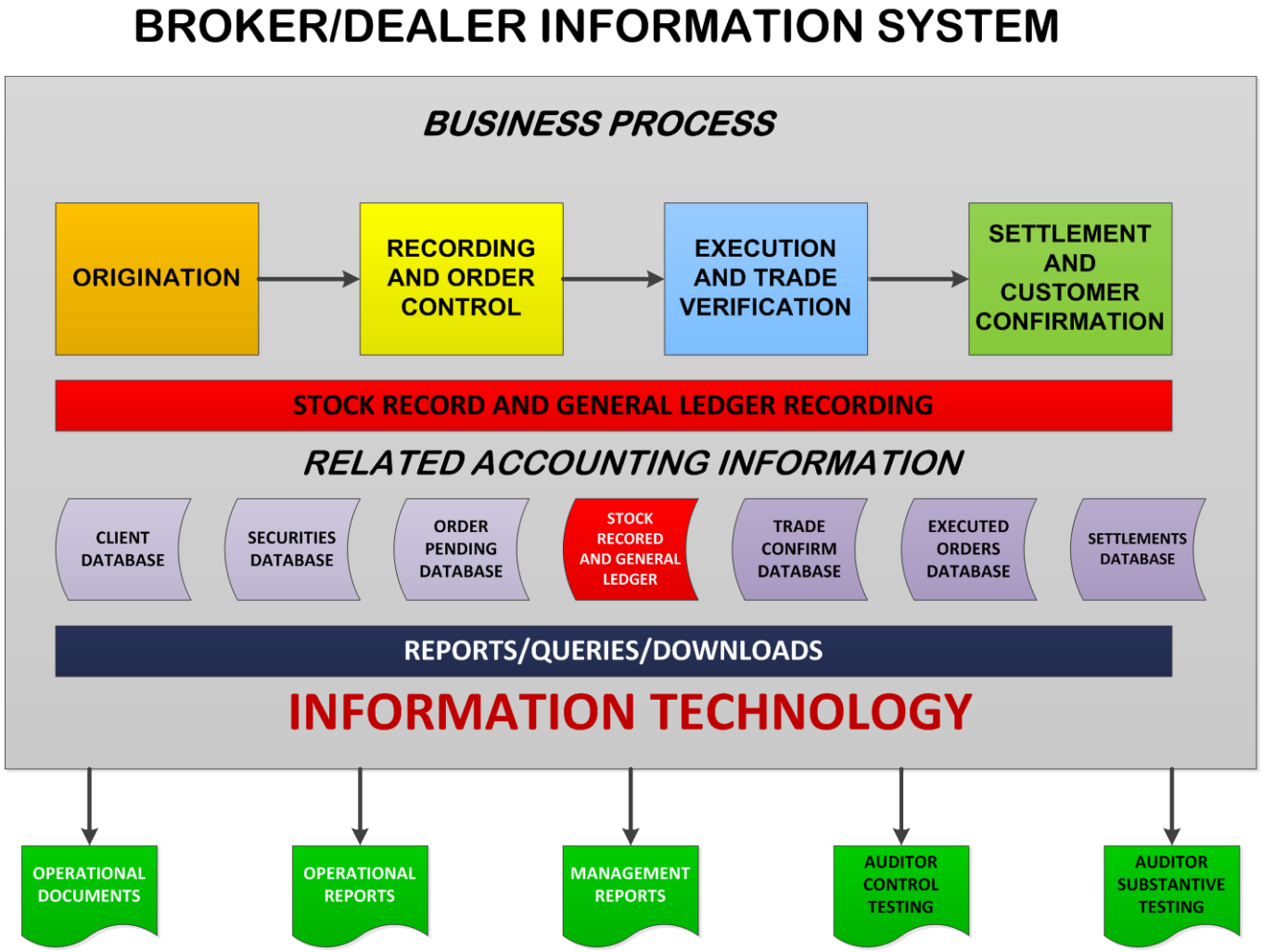
Firms did not perform sufficient procedures to place reliance on records and reports of the broker or dealer or reports from service organizations that were used in audit procedures.

Establishing a Basis for Reliance on Records and Reports

PCAOB Observation

- Did not obtain and evaluate a service auditor's report, or did not perform procedures regarding the accuracy and completeness of the information obtained from the service organization
- Obtained a service auditor's report, but failed to evaluate the service auditor's report or failed to consider whether the service auditor's report provided evidence about the design and operating effectiveness of the controls being relied upon.

Establishing a Basis for Reliance on Records and Reports



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Establishing a Basis for Reliance on Records and Reports

AU 326 ***Audit Evidence***

.10 "When information produced by the entity is used by the auditor to perform further audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information. In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate. For example, in auditing revenue by applying standard prices to records of sales volume, the auditor should consider the accuracy of the price information and the completeness and accuracy of the sales volume data..."

Establishing a Basis for Reliance on Records and Reports

End user computing

- **IT risks can be mitigated by:**
  - Reconciling spread sheet data to transactions (to source to achieve accuracy; from source to achieve completeness).
  - Establishing locking schemes over formula cells.
  - Determining access controls over spread sheets (password protection, secured server).
  - Evaluating end-to-end controls over critical systems interfaces (automated or manual).
  - Assessing change management process over end-user created reports.

Establishing a Basis for Reliance on Records and Reports

AU 324 *Service Organizations*

.12 “A service auditor's report on controls placed in operation at the service organization should be helpful in providing a sufficient understanding to assess the risks of material misstatement of the user organization. Such a report, however, is not intended to provide any evidence of the operating effectiveness of the relevant controls that would allow the user auditor to reduce the assessed level of control risk as low or moderate. Such audit evidence should be derived from one or more of the following:

a) Tests of the user organization's controls over the activities of the service organization...

b) A service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls

c) Appropriate tests of controls performed by the user auditor at the service organization”

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Establishing a Basis for Reliance on Records and Reports

Example #1

Broker A's trading system calculates commission revenue. Auditor agrees the commission revenue report for the fiscal year from the system to the balance on the general ledger for the fiscal year.

What else does the auditor need to do to establish a reasonable basis for reliance on the commission revenue report?

Establishing a Basis for Reliance on Records and Reports

Example #2

Broker B's trading system calculates commission revenue. Auditor agrees the commission revenue report for the fiscal year from the system to the balance on the general ledger for the fiscal year. Auditor also agrees commission rates used in the system to a spreadsheet (rate table) provided by the broker.

What else does the auditor need to do to establish a reasonable basis for reliance on the commission revenue report?

Establishing a Basis for Reliance on Records and Reports

Example #3

Broker C uses a clearing firm to process and settle transactions and receives a monthly statement indicating commission revenue for the period. Auditor agrees revenue recorded to cash received and to the statements from the clearing firm for the year. Auditor obtains a service auditor's report.

What else does the auditor need to do to establish a reasonable basis for reliance on commission revenue reported on the clearing firm statements?

Fair Value Measurements

PCAOB Observation

Firms did not perform sufficient procedures to test the valuation of securities.

Fair Value Measurements

AU 328 ***Auditing Fair Value Measurements and Disclosures***

.40 "…Instead of using management's assumptions, the auditor may develop his or her own assumptions to make a comparison with management's fair value measurements. In that situation, the auditor nevertheless understands management's assumptions. The auditor uses that understanding to ensure that his or her independent estimate takes into consideration all significant variables and to evaluate any significant difference from management's estimate. The auditor also should test the data used to develop the fair value measurements and disclosures as discussed in paragraph .39 [of AU 328]."

Fair Value Measurements

Example

The Auditor obtained fair values from a pricing service for all level 2 securities owned and securities sold, not yet purchased, and compared those prices to the Broker's values. Included in those securities are asset-backed securities, mortgage-backed securities, and corporate private placement securities.

What else does the auditor need to do, if anything, to conclude on the reasonableness of the fair values?

Evaluation of Internal Control Deficiencies

PCAOB Observation

- Errors were identified during the performance of substantive tests, yet the firms failed to evaluate the severity and nature of the errors and the circumstances of their occurrences, including whether the errors were evidence of one or more control deficiencies.
- Internal control deficiencies were identified during procedures to obtain an understanding of internal controls, but the potential effect of which was not sufficiently evaluated.

Evaluation of Internal Control Deficiencies

AU 325 ***Communicating Internal Control Related Matters Identified in an Audit***

.05 A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

A deficiency in *design* exists when

- a control necessary to meet the control objective is missing; or
- an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

A deficiency in *operation* exists when

- a properly designed control does not operate as designed; or
- the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Evaluation of Internal Control Deficiencies

Example

The Auditor detected an error in Broker A's net capital computation, but the error was not detected by the broker's CFO during the CFO's review of the FOCUS report. Based on the Auditor's knowledge of the CFO, the Auditor has determined that the CFO possesses sufficient industry knowledge and expertise to perform the review of the FOCUS report.

What factors does the auditor need to consider to determine whether an internal control deficiency exists?

Financial Statement Disclosures

PCAOB Observation

Firms failed to perform sufficient audit procedures to test the accuracy and completeness of certain financial statement disclosures:

- Omission of disclosures
- Fair Value Hierarchy (ASC 820)

Conclusion

- First annual progress report issued August 20, 2012
- Interim inspection program continues
- Gathering information to assist the Board
- Inspecting for audit quality
- Determination of the scope and elements of a permanent inspection program

Questions?

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Break

(15 minutes)

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Update on PCAOB Standard-Setting Activities

Barbara Vanich
Associate Chief Auditor

October 25, 2012

Jersey City, NJ

What We Will Cover

- Auditing Standard No. 16, *Communications with Audit Committees*
- Auditor's Reporting Model
- Auditor Independence and Audit Firm Rotation
- Improving Transparency Through Disclosure of Engagement Partner and Certain Other Participants in Audits
- Related Parties
- Other Standard-Setting Activities

AS No. 16 - *Communications with Audit Committees*

- On August 14, 2012, the Board adopted Auditing Standard No. 16, *Communications with Audit Committees*, and related amendments.
  - AS No. 16 is effective, pending SEC approval, for audits beginning on or after December 15, 2012.
- AS No. 16 requires communications with the audit committee to be made in a timely manner and prior to the issuance of the audit report.
- Auditing Standard No. 16 -
  - Provides a definition of audit committee;
  - Retains or enhances existing communication requirements;
  - Incorporates certain SEC auditor communication requirements to audit committees; and
  - Adds new communication requirements that are generally linked to performance requirements in other PCAOB standards.

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AS No. 16 - *Communications with Audit Committees* (continued)

- Definition of Audit Committee – For audits of issuers, AS No. 16 retains the definition of audit committee from the Sarbanes-Oxley Act. For audits of nonissuers, the definition of audit committee provides that if no audit committee or board of directors (or equivalent body) exists with respect to the company the communications should be made to the person(s) who oversee the accounting and financial reporting processes of the company and audits of the financial statements of the company.
- Enhances existing requirements by requiring the auditor to –
  - Establish an understanding of the audit with the audit committee and recording the terms of the engagement in an engagement letter;
  - Communicate certain matters regarding the company's accounting policies, practices, and estimates;
  - Communicate the auditor's evaluation of the quality of the company's financial reporting;
  - Communicate information related to significant unusual transactions; and
  - Communicate the auditor's views regarding significant accounting or auditing matters when the auditor is aware that management consulted with other accountants about such matters and the auditor has identified a concern regarding these matters.

AS No. 16 - *Communications with Audit Committees* (continued)

- Incorporate SEC communication requirements –
  - All critical accounting policies and practices to be used;
  - All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and
  - Other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

AS No. 16 - *Communications with Audit Committees* (continued)

- Adds new requirements that are generally linked to performance requirements in other PCAOB standards or the conduct of the audit, which require the auditor to communicate –
  - An overview of the overall audit strategy, including timing of the audit, significant risks the auditor identified, and significant changes to the planned audit strategy or identified risks;
  - Information about others involved in the audit, including internal auditors and other independent public accounting firms;
  - The basis for the auditor's determination that he or she can serve as principal auditor, if significant parts of the audit will be performed by other auditors;
  - Difficult or contentious matters for which the auditor consulted outside the engagement team;
  - The auditor's evaluation of the company's ability to continue as a going concern;
  - Departure from the auditor's standard report; and
  - Other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

Auditor's Reporting Model

- On June 21, 2011, the Board issued a concept release on possible changes to the auditor's reporting model.
  - The concept release was influenced by outreach conducted by the staff of the Office of the Chief Auditor from October 2010 through March 2011 with investors, auditors, preparers, audit committee members, and others.
- The concept release discusses four alternatives for changing the auditor's reporting model (auditor's discussion and analysis, required and expanded use of emphasis paragraphs, auditor assurance on other information outside the financial statements, and clarification of language in the standard auditor's report).
- The Board hosted a roundtable on September 15, 2011 to discuss the alternatives in the concept release.
- The comment period ended on September 30, 2011; over 150 comment letters received.
- PCAOB planned activities
  - 2012 – Propose standard
  - 2013 – Re-propose or final standard

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Auditor Independence and Audit Firm Rotation

- On August 16, 2011, the Board issued a concept release to solicit public comment on ways that auditor independence, objectivity, and professional skepticism could be enhanced, including through mandatory rotation of audit firms.
- The concept release invites commenters to respond to specific questions, including, for example, whether the Board should consider a rotation requirement only for audit tenures of more than 10 years or only for the largest issuer audits.
- The concept release also seeks comment on whether there are other measures that could meaningfully enhance auditor independence, objectivity, and professional skepticism.

Auditor Independence and Audit Firm Rotation (continued)

- The Board hosted public meetings:
  - Washington, DC – March 21-22, 2012
  - San Francisco – June 28, 2012
- The initial comment period closed on December 14, 2011. In light of the above-mentioned public meetings hosted by the Board, the comment period was reopened and closed on July 28, 2012.
- The staff is analyzing over 670 comment letters.

Improving Transparency Through Disclosure of Engagement Partner and Certain Other Participants in Audits

- On October 11, 2011, the Board issued proposed amendments to improve transparency through disclosure of the engagement partner and certain other participants in audit reports.
- Investors have requested greater transparency into other firms and persons performing audit procedures and how much of the audit they have performed.
- The proposed amendments have been informed by comments from the Board's 2009 concept release on engagement partner signature.

Improving Transparency (continued)

- The proposed amendments would:
  - Require registered public accounting firms to disclose the name of the engagement partner in the audit report
  - Amend the Board's Annual Report Form to require registered firms to disclose the name of the engagement partner for each audit report already required to be reported on the form
  - Require disclosure in the audit report of the names, locations, and extent of participation in the audit of other accounting firms and other persons that took part in the audit.
- The comment period ended on January 9, 2012; 42 comment letters received.

Related Parties

- On February 28, 2012, the Board proposed for comment an auditing standard on Related Parties and amendments to procedures regarding significant unusual transactions and a company's relationships with its executive officers.
- The proposed standard and proposed amendments would address the following areas:
  - Evaluating a company's identification of, accounting for, and disclosure of relationships and transactions between the company and its related parties.
  - Identifying and evaluating a company's significant unusual transactions.
  - Obtaining an understanding of a company's financial relationships and transactions with its executive officers, as part of the auditor's risk assessment.
- The comment period ended on May 31, 2012; 37 comment letters received.

Other Standard-Setting Activities*

- Confirmation
- Assignment and Documentation of Supervisory Responsibilities within a Firm
- Going Concern
- Audits of Brokers and Dealers
- Auditing Supplemental Information

* Activities subject to change based on emerging issues

Other Standard-Setting Activities*

- Using the Work of Other Independent Auditors
- Specialists
- Fair Value Measurements and Other Accounting Estimates
  - Third-Party Pricing Sources
- Quality Control Standards
- Codification of Auditing Standards

* Activities subject to change based on emerging issues

Keeping Current with Standard-Related Activities

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Keeping Current with Standard-Related Activities

- Our Web site – http://www.pcaobus.org/Standards/Pages/default.aspx
  - PCAOB standards and related rules, including interim standards
  - PCAOB proposed standards
  - Staff Questions and Answers
  - Staff Audit Practice Alerts
  - Standing Advisory Group
- Contact us at info@pcaobus.org
- Sign up for the PCAOB Updates service to receive a notification via e-mail that briefly describes significant new postings to our Web site at:

http://pcaobus.org/About/Pages/Subscribe.aspx

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Questions?

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Disciplinary Process:
An Overview

Michelle Jaconski

Division of Enforcement and Investigations

Division of Enforcement and Investigations Overview

- Staff consists of 27 attorneys, 17 accountants, and support staff, totaling over fifty staff based in DC and NY offices
- Enforcement's role:
  - Identify appropriate matters for investigation
  - Conduct investigations and make recommendations to the Board
  - Litigate disciplinary proceedings before Board's Hearing Officer and, on appeal, to the Board
  - Manage Board's tips process

Enforcement's Jurisdiction

- Registered Public Accounting Firms
  - Audits of "Issuers" (*i.e.*, public companies) and Broker/Dealers
- "Associated Persons"

Enforcement and Investigations

- The PCAOB may investigate possible violations by registered public accounting firms or their associated persons of:
  - Any relevant provision of the Sarbanes-Oxley Act
  - The rules of the Board
  - The provisions of the securities laws relating to the preparation and issuance of audit reports
  - Professional standards

Sources of Investigations

- Enforcement public source analysis:
  - Public disclosures by Issuers and Broker/Dealers
  - Media reports, blogs, and analyst reports
  - Tips
- Referrals from other regulators, *e.g.*, SEC, FINRA, Exchanges
- Other PCAOB divisions and offices
  - Division of Registration and Inspections
  - Office of Research and Analysis

Inspections Referred to Enforcement

- Situations in which the Board may use its investigative resources instead of relying solely on its inspections process:
  - Possible illegal acts known to auditor
  - Unethical conduct by auditor
  - Significant departure from PCAOB standards
  - Material departure from GAAP
  - Failure to cooperate with inspections
  - Potential Independence violations

Common Types of Investigations

- Violations of professional standards
  - Failure to obtain sufficient audit evidence, exercise due care and professional skepticism (ignored red flags)
  - Failure of firm quality control procedure to operate effectively
- Independence violations
- Failure to cooperate with an inspection or investigation

Investigations Process Overview

- The Act requires confidentiality of investigative information
- Most matters start as informal inquiries—reliance on voluntary productions based on Division requests
- If matter warrants significant use of resources, or parties are not complying with requests, Staff requests an Order of Formal Investigation from the Board
  - "Accounting Board Demands" compel firms/associated persons to
    - Produce documents
    - Testify
    - Provide other information
  - Refusal to comply may amount to sanctionable non-cooperation

Investigations Process Overview

- The staff conducts its fact-finding
  - Obtains documents and information from the firm, its personnel, and other sources (can include its client)
  - Reviews documents
  - Takes testimony (a form of deposition) from relevant firm personnel
- At the conclusion of the fact-finding, the staff reviews the evidentiary record (testimony transcripts and documents) for serious violations

Investigations Process Overview

- If evidence of serious violations exist
  - Staff communicates to the firm or associated persons and gives them an opportunity to respond to staff's position in writing
  - Staff reviews the responses and determines whether to recommend charges against firm(s) and/or associated person(s), or closure of the formal investigation
  - Staff communicates recommendations to the Board

Investigation Process Overview

- Enforcement recommendations to the Board for disciplinary proceedings
  - Enforcement submits a memorandum to the Board outlining facts and law and parties to be charged with violations
    - If Board approves litigated proceeding, order is nonpublic
  - If parties wish to settle, the recommendation will include whether acceptance of the settlement is recommended by the Division
    - If Board approves settlement, order becomes public

Disciplinary Proceedings and Hearings

- Hearings (trials) are conducted by the Board Hearing Officer to determine whether firms or associated persons committed violations and should be disciplined
- Hearings are nonpublic, as required by Act
- Initial decision by Board's Hearing Officer
- Any sanctions imposed can be appealed to the Board, then to the SEC, and then to the United States Circuit Court

Sanctions

- In a disciplinary proceeding, the Board may
  - Suspend or permanently bar an individual from association with a registered public accounting firm (*e.g.* Chisholm, et al.)
  - Temporarily or permanently revoke a firm's registration (*e.g.* Moore & Assoc.)
  - Temporarily or permanently limit the activities, functions, or operations of a firm or person
  - Appoint an independent monitor (*e.g.* PW India /Satyam)
  - Impose a civil money penalty (*e.g.* $2M, Ernst & Young LLP /Medicis)
  - Impose a censure, require additional professional education or training, and/or impose any other sanction allowed by the Board rules

Effect of Suspension or Bar

- A person suspended or barred from associating with a registered public accounting firm by the Board is prohibited from associating with a registered public accounting firm
- Dodd-Frank also makes it unlawful for the person to associate with any issuer, broker, or dealer in an accountancy or a financial management capacity

Settled and Adjudicated Disciplinary Proceedings

- To date the Board has settled or completed adjudication on over 40 disciplinary orders
- These orders have resulted in the following sanctions:
  - Bars (Firms and auditors)
  - Suspensions
  - Censures
  - Civil money penalties

Settled Disciplinary Proceeding

- In the Matters of Peter C. O'Toole, CPA; Darrin G. Estella, CPA; and Jacqueline A. Higgins, CPA
  - Partner, Sr. Manager and Manager at Ernst & Young
  - Failed to comply with AS3 (*Audit Documentation*) and failed to cooperate with Inspections
  - Improperly removed, added and backdated working papers in advance of an inspection
  - Partner received bar (can petition for Board consent to associate with a registered public accounting firm after 3 years) and $50,000 civil money penalty
  - Sr. Manager barred (can petition for Board consent to associate with a registered public accounting firm after 2 years)
  - Manager censured

Settled Disciplinary Proceeding

- In the Matter of J. Crane CPA, P.C. and James Crane
  - Failed to cooperate with Inspections
  - Failed to file annual report and pay annual fee
  - Firm's registration permanently revoked, Individual permanently barred

Adjudicated Disciplinary Proceeding

- In the Matter of Davis Accounting Group, P.C. and Edwin R. Davis, Jr., CPA
  - Audit firm and its sole owner failed to cooperate with a PCAOB investigation
  - While the firm and its sole owner continued to issue more than 30 audit opinions, they claimed they were unable to respond to an Accounting Board Demand
  - Firm's registration was permanently revoked and its sole owner was permanently barred from association, with monetary sanctions of $75,000

PCAOB Center for Enforcement Tips, Complaints and Other Information

Website:	http://pcaobus.org/Enforcement/Tips
Letter:	PCAOB Tip Center
	1666 K Street, NW
	Washington, DC 20006
FAX:	202-862-0757
Telephone:	800-741-3158

Questions?

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PCAOB/SEC/FINRA Panel

Moderator: Jay Hanson

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Closing Remarks and Wrap-Up

Jay Hanson
Board Member, PCAOB
October 25, 2012
Jersey City, NJ